

(iv) Based on Table H of Publication 1457 (a copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402), the present value of an annuity of \$67,287.26 per year payable for 17 years or until the prior death of a person aged 60 is \$579,484.61 ($\$67,287.26 \times 8.6121$). The present value of an annuity of \$32,712.74 per year payable for 18 years or until the prior death of a person aged 60 is \$287,731.45 ($\$32,712.74 \times 8.7957$). Thus, the present value of the charitable annuity interest is \$867,216.06 ($\$579,484.61 + \$287,731.45$).

(3) *Mortality component.* The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date the gift is completed, that individual shall be presumed to have not been terminally ill at the date the gift was completed unless the contrary is established by clear and convincing evidence.

(4) *Example.* The provisions of paragraph (b)(3) of this section are illustrated by the following example:

Example. Terminal illness. The donor transfers property worth \$1,000,000 to a child in exchange for the child's promise to pay the donor \$103,000 per year for the donor's life. The donor is age 60 but has been diagnosed with an incurable illness and has at least a 50 percent probability of dying within 1 year. The section 7520 interest rate for the month of the transfer is 10.6 percent, and the standard annuity factor at that interest rate for a person age 60 in normal health is 7.4230. Thus, if the donor were not terminally ill, the present value of the annuity would be \$764,569 ($\$103,000 \times 7.4230$). Assuming the presumption provided in paragraph (b)(3) of this section does not apply, because there is at least a 50 percent probability that the donor will die within 1 year, the standard section 7520 annuity factor may not be used to determine the present value of the donor's annuity interest. Instead, a special section 7520 annuity factor must be computed that takes

into account the projection of the donor's actual life expectancy.

(5) *Additional limitations.* Section 7520 does not apply to the extent as may otherwise be provided by the Commissioner.

(c) *Effective date.* Section 25.7520-3(a) is effective as of May 1, 1989. The provisions of paragraph (b) of this section are effective with respect to gifts made after December 13, 1995.

[T.D. 8540, 59 FR 30177, June 10, 1994, as amended by T.D. 8630, 60 FR 63919, Dec. 13, 1995]

§ 25.7520-4 Transitional rules.

(a) *Reliance.* If the valuation date is after April 30, 1989, and before June 10, 1994, a donor can rely on Notice 89-24, 1989-1 C.B. 660, or Notice 89-60, 1989-1 C.B. 700 (See § 601.601(d)(2)(ii)(b) of this chapter), in valuing the transferred interest.

(b) *Transfers in 1989.* If a donor transferred an interest in property by gift after December 31, 1988, and before May 1, 1989, retaining an interest in the same property and, after April 30, 1989, and before January 1, 1990, transferred the retained interest in the property, the donor may, at the donor's option, value the transfer of the retained interest under either § 25.2512-5(d) or § 25.2512-5A(d).

(c) *Effective date.* This section is effective as of May 1, 1989.

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

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Internal Revenue Service, Treasury

§ 26.2600-1

- 26.2652-2 Special election for qualified terminable interest property.
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- 26.2663-2 Application of chapter 13 to transfers by nonresidents not citizens of the United States.

AUTHORITY: 26 U.S.C. 7805 and 26 U.S.C. 2663.

Section 26.2632-1 also issued under 26 U.S.C. 2632 and 2663.

Section 26.2642-4 also issued under 26 U.S.C. 2632 and 2663.

Section 26.2662-1 also issued under 26 U.S.C. 2662.

Section 26.2663-2 also issued under 26 U.S.C. 2632 and 2663.

SOURCE: T.D. 8644, 60 FR 66903, Dec. 27, 1995, unless otherwise noted.

§ 26.2600-1 Table of contents.

This section lists the captions that appear in the regulations under sections 2601 through 2663.

§ 26.2601-1 Effective dates.

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 - (2) Certain transfers treated as if made after October 22, 1986.
 - (3) Certain trust events treated as if occurring after October 22, 1986.
 - (4) Example.
- (b) Exceptions.
 - (1) Irrevocable trusts.
 - (2) Transition rule for wills or revocable trusts executed before October 22, 1986.
 - (3) Transition rule in the case of mental incompetency.
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 - (c) Additional effective dates.

§ 26.2611-1 Generation-skipping transfer defined.

§ 26.2612-1 Definitions.

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 - (2) Special rule for certain lineal descendants.
- (b) Taxable termination. P≤(1) In general.
- (2) Partial termination.
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 - (2) Look-through rule not to apply.
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- (e) Interest in trust.
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§ 26.2613-1 Skip person.

§ 26.2632-1 Allocation of GST exemption.

- (a) General rule.
- (b) Lifetime allocations.
 - (1) Automatic allocation to direct skips.
 - (2) Allocation to other transfers.
- (c) Special rules during an estate tax inclusion period.
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 - (2) Estate tax inclusion period defined.
 - (3) Termination of an ETIP.
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 - (1) Allocation by executor.
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 - (2) GSTs occurring during an ETIP.
- (c) Denominator of applicable fraction.
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§ 26.2642-2 Valuation.

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 - (2) Special rule for late allocations during life.
- (b) Transfers at death.
 - (1) In general.
 - (2) Special rule for pecuniary payments.
 - (3) Special rule for residual transfers after payment of a pecuniary payment.
 - (4) Appropriate interest.
 - (c) Examples.

§ 26.2642-3 Special rule for charitable lead annuity trusts.

- (a) In general.
- (b) Adjusted GST exemption defined.
- (c) Example.

§ 26.2642-4 Redetermination of applicable fraction.

- (a) In general.
 - (1) Multiple transfers to a single trust.
 - (2) Consolidation of separate trusts.
 - (3) Property included in transferor's gross estate.
 - (4) Imposition of recapture tax under section 2032A.
- (b) Examples.

§ 26.2642-5 Finality of inclusion ratio.

- (a) Direct skips.

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- (b) Other GSTs.

§ 26.2652-1 Transferor defined; other definitions.

- (a) Transferor defined.
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(2) Transfers subject to Federal estate or gift tax.
(3) Special rule for certain QTIP trusts.
(4) Exercise of certain nongeneral powers of appointment.
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(b) Trust defined.
(1) In general.
(2) Examples.
(c) Trustee defined.
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§ 26.2652-2 Special election for qualified terminable interest property.

- (a) In general.
(b) Time and manner of making election.
(c) Transitional rule.
(d) Examples.

§ 26.2653-1 Taxation of multiple skips.

- (a) General rule.
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- (a) Single trust treated as separate trusts.
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(2) Special rule.
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(2) Taxable terminations.
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(3) Limitation on personal liability of trustee.
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- (2) Exceptions for alternative valuation of taxable termination.

- (e) Place for filing returns.
(f) Lien on property.

§ 26.2663-1 Recapture tax under section 2032A.

§ 26.2663-2 Application of chapter 13 to transfers by nonresidents not citizens of the United States.

- (a) In general.
(b) Transfers subject to Chapter 13.
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(2) Taxable distributions and taxable terminations.
(c) Trusts funded in part with property subject to Chapter 13 and in part with property not subject to Chapter 13.
(1) In general.
(2) Nontax portion of the trust.
(3) Special rule with respect to estate tax inclusion period.
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(e) Transitional rule for allocations for transfers made before December 27, 1995.

26.2601-1 Effective dates.

(a) *Transfers subject to the generation-skipping transfer tax*—(1) *In general.* Except as otherwise provided in this section, the provisions of chapter 13 of the Internal Revenue Code of 1986 (Code) apply to any generation-skipping transfer (as defined in section 2611) made after October 22, 1986.

(2) *Certain transfers treated as if made after October 22, 1986.* Solely for purposes of chapter 13, an inter vivos transfer is treated as if it were made on October 23, 1986, if it was—

(i) Subject to chapter 12 (regardless of whether a tax was actually incurred or paid); and

(ii) Made after September 25, 1985, but before October 23, 1986. For purposes of this paragraph, the value of the property transferred shall be the value of the property on the date the property was transferred.

(3) *Certain trust events treated as if occurring after October 22, 1986.* For purposes of chapter 13, if an inter vivos transfer is made to a trust after September 25, 1985, but before October 23, 1986, any subsequent distribution from the trust or termination of an interest in the trust that occurred before October 23, 1986, is treated as occurring immediately after the deemed transfer on October 23, 1986. If more than one distribution or termination occurs with

respect to a trust, the events are treated as if they occurred on October 23, 1986, in the same order as they occurred. See paragraph (b)(1)(iv)(B) of this section for rules determining the portion of distributions and terminations subject to tax under chapter 13. This paragraph (a)(3) does not apply to transfers to trusts not subject to chapter 13 by reason of the transition rules in paragraphs (b) (2) and (3) of this section. The provisions of this paragraph (a)(3) do not apply in determining the value of the property under chapter 13.

(4) *Example.* The following example illustrates the principle that paragraph (a)(2) of this section is not applicable to transfers under a revocable trust that became irrevocable by reason of the transferor's death after September 25, 1985, but before October 23, 1986:

Example. T created a revocable trust on September 30, 1985, that became irrevocable when T died on October 10, 1986. Although the trust terminated in favor of a grandchild of T, the transfer to the grandchild is not treated as occurring on October 23, 1986, pursuant to paragraph (a)(2) of this section because it is not an inter vivos transfer subject to chapter 12. The transfer is not subject to chapter 13 because it is in the nature of a testamentary transfer that occurred prior to October 23, 1986.

(b) *Exceptions—(1) Irrevocable trusts—(i) In general.* The provisions of chapter 13 do not apply to any generation-skipping transfer under a trust (as defined in section 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985. See paragraph (b)(1)(iv) of this section for rules for determining the portion of the trust that is subject to the provisions of chapter 13.

(ii) *Irrevocable trust defined—(A) In general.* Unless otherwise provided in either paragraph (b)(1)(ii) (B) or (C) of this section, any trust (as defined in section 2652(b)) in existence on September 25, 1985, is considered an irrevocable trust.

(B) *Property includible in the gross estate under section 2038.* For purposes of this chapter a trust is not an irrevocable trust to the extent that, on September 25, 1985, the settlor held a

power with respect to such trust that would have caused the value of the trust to be included in the settlor's gross estate for Federal estate tax purposes by reason of section 2038 (without regard to powers relinquished before September 25, 1985) if the settlor had died on September 25, 1985. A trust is considered subject to a power on September 25, 1985, even though the exercise of the power was subject to the precedent giving of notice, or even though the exercise could take effect only on the expiration of a stated period, whether or not on or before September 25, 1985, notice had been given or the power had been exercised. A trust is not considered subject to a power if the power is, by its terms, exercisable only on the occurrence of an event or contingency not subject to the settlor's control (other than the death of the settlor) and if the event or contingency had not in fact taken place on September 25, 1985.

(C) *Property includible in the gross estate under section 2042.* A policy of insurance on an individual's life that is treated as a trust under section 2652(b) is not considered an irrevocable trust to the extent that, on September 25, 1985, the insured possessed any incident of ownership (as defined in §20.2042-1(c) of this chapter, and without regard to any incidents of ownership relinquished before September 25, 1985), that would have caused the value of the trust, (i.e., the insurance proceeds) to be included in the insured's gross estate for Federal estate tax purposes by reason of section 2042, if the insured had died on September 25, 1985.

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(1):

EXAMPLE 1. Section 2038 applicable. On September 25, 1985, T, the settlor of a trust that was created before September 25, 1985, held a testamentary power to add new beneficiaries to the trust. T held no other powers over any portion of the trust. The testamentary power held by T would have caused the trust to be included in T's gross estate under section 2038 if T had died on September 25, 1985. Therefore, the trust is not an irrevocable trust for purposes of this section.

EXAMPLE 2. Section 2038 not applicable when power held by a person other than settlor. On September 25, 1985, S, the spouse of the settlor of a trust in existence on that date, had

an annual right to withdraw a portion of the principal of the trust. The trust was otherwise irrevocable on that date. Because the power was not held by the settlor of the trust, it is not a power described in section 2038. Thus, the trust is considered an irrevocable trust for purposes of this section.

EXAMPLE 3. Section 2038 not applicable. In 1984, T created a trust and retained the right to expand the class of remaindermen to include any of T's afterborn grandchildren. As of September 25, 1985, all of T's grandchildren were named remaindermen of the trust. Since the exercise of T's power was dependent on there being afterborn grandchildren who were not members of the class of remaindermen, a contingency that did not exist on September 25, 1985, the trust is not considered subject to the power on September 25, 1985, and is an irrevocable trust for purposes of this section. The result is not changed even if grandchildren are born after September 25, 1985, whether or not T exercises the power to expand the class of remaindermen.

EXAMPLE 4. Section 2042 applicable. On September 25, 1985, T purchased an insurance policy on T's own life and designated child, C, and grandchild, GC, as the beneficiaries. T retained the power to obtain from the insurer a loan against the surrender value of the policy. T's insurance policy is a trust (as defined in section 2652(b)) for chapter 13 purposes. The trust is not considered an irrevocable trust because, on September 25, 1985, T possessed an incident of ownership that would have caused the value of the policy to be included in T's gross estate under section 2042 if T had died on that date.

EXAMPLE 5. Trust partially irrevocable. In 1984, T created a trust naming T's grandchildren as the income and remainder beneficiaries. T retained the power to revoke the trust as to one-half of the principal at any time prior to T's death. T retained no other powers over the trust principal. T did not die before September 25, 1985, and did not exercise or release the power before that date. The half of the trust not subject to T's power to revoke is an irrevocable trust for purposes of this section.

(iii) *Trust containing qualified terminable interest property—(A) In general.* For purposes of chapter 13, a trust described in paragraph (b)(1)(ii) of this section that holds qualified terminable interest property by reason of an election under section 2056(b)(7) or section 2523(f) (made either on, before or after September 25, 1985) is treated in the same manner as if the decedent spouse or the donor spouse (as the case may be) had made an election under section 2652(a)(3). Thus, transfers from such

trusts are not subject to chapter 13, and the decedent spouse or the donor spouse (as the case may be) is treated as the transferor of such property. The rule of this paragraph (b)(1)(iii) does not apply to that portion of the trust that is subject to chapter 13 by reason of an addition to the trust occurring after September 25, 1985. See §26.2652-2(a) for rules where an election under section 2652(a)(3) is made. See §26.2652-2(c) for rules where a portion of a trust is subject to an election under section 2652(a)(3).

(B) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(iii):

EXAMPLE 1. QTIP election made after September 25, 1985. On March 28, 1985, T established a trust. The trust instrument provided that the trustee must distribute all income annually to T's spouse, S, during S's life. Upon S's death, the remainder is to be distributed to GC, the grandchild of T and S. On April 15, 1986, T elected under section 2523(f) to treat the property in the trust as qualified terminable interest property. On December 1, 1987, S died and soon thereafter the trust assets were distributed to GC. Because the trust was irrevocable on September 25, 1985, the transfer to GC is not subject to tax under chapter 13. T is treated as the transferor with respect to the transfer of the trust assets to GC in the same manner as if T had made an election under section 2652(a)(3) to reverse the effect of the section 2523(f) election for chapter 13 purposes.

EXAMPLE 2. Section 2652(a)(3) election deemed to have been made. Assume the same facts as in *Example 1*, except the trust instrument provides that after S's death all income is to be paid annually to C, the child of T and S. Upon C's death, the remainder is to be distributed to GC. C died on October 1, 1992, and soon thereafter the trust assets are distributed to GC. Because the trust was irrevocable on September 25, 1985, the termination of C's interest is not subject to chapter 13.

(iv) *Additions to irrevocable trusts—(A) In general.* If an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion)

and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under section 2642. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under paragraph (b)(1)(v) of this section is treated as an addition. See paragraph (b)(4) of this section for exceptions to the additions rule of this paragraph (b)(1)(iv). See §26.2654-1(a)(2) for rules treating additions to a trust by an individual other than the initial transferor as a separate trust for purposes of chapter 13.

(B) *Terminations of interests in and distributions from trusts.* Where a termination or distribution described in section 2612 occurs with respect to a trust to which an addition has been made, the portion of such termination or distribution allocable to the chapter 13 portion is determined by reference to the allocation fraction, as defined in paragraph (b)(1)(iv)(C) of this section. In the case of a termination described in section 2612(a) with respect to a trust, the portion of such termination that is subject to chapter 13 is the product of the allocation fraction and the value of the trust (to the extent of the terminated interest therein). In the case of a distribution described in section 2612(b) from a trust, the portion of such distribution that is subject to chapter 13 is the product of the allocation fraction and the value of the property distributed.

(C) *Allocation fraction—(1) In general.* The allocation fraction allocates appreciation and accumulated income between the chapter 13 and non-chapter 13 portions of a trust. The numerator of the allocation fraction is the amount of the addition (valued as of the date

the addition is made), determined without regard to whether any part of the transfer is subject to tax under chapter 11 or chapter 12, but reduced by the amount of any Federal or state estate or gift tax imposed and subsequently paid by the recipient trust with respect to the addition. The denominator of the allocation fraction is the total value of the entire trust immediately after the addition. For purposes of this paragraph (b)(1)(iv)(C), the total value of the entire trust is the fair market value of the property held in trust (determined under the rules of section 2031), reduced by any amount attributable to or paid by the trust and attributable to the transfer to the trust that is similar to an amount that would be allowable as a deduction under section 2053 if the addition had occurred at the death of the transferor, and further reduced by the same amount that the numerator was reduced to reflect Federal or state estate or gift tax incurred by and subsequently paid by the recipient trust with respect to the addition. Where there is more than one addition to principal after September 25, 1985, the portion of the trust subject to chapter 13 after each such addition is determined pursuant to a revised fraction. In each case, the numerator of the revised fraction is the sum of the value of the chapter 13 portion of the trust immediately before the latest addition, and the amount of the latest addition. The denominator of the revised fraction is the total value of the entire trust immediately after the addition. If the transfer to the trust is a generation-skipping transfer, the numerator and denominator are reduced by the amount of the generation-skipping transfer tax, if any, that is imposed by chapter 13 on the transfer and actually recovered from the trust. The allocation fraction is rounded off to five decimal places (.00001).

(2) *Examples.* The following examples illustrate the application of paragraph (b)(1)(iv) of this section. In each of the examples, assume that the recipient trust does not pay any Federal or state transfer tax by reason of the addition.

EXAMPLE 1. *Post September 25, 1985, addition to trust.* (i) On August 16, 1980, T established

an irrevocable trust. Under the trust instrument, the trustee is required to distribute the entire income annually to T's child, C, for life, then to T's grandchild, GC, for life. Upon GC's death, the remainder is to be paid

to GC's issue. On October 1, 1986, when the total value of the entire trust is \$400,000, T transfers \$100,000 to the trust. The allocation fraction is computed as follows:

$$\frac{\text{Value of addition}}{\text{Total value of trust}} = \frac{\$100,000}{\$400,000 + \$100,000} = .2$$

(ii) Thus, immediately after the transfer, 20 percent of the value of future generation-skipping transfers under the trust will be subject to chapter 13.

EXAMPLE 2. *Effect of expenses.* Assume the same facts as in *Example 1*, except immediately prior to the transfer on October 1, 1986, the fair market value of the individual assets in the trust totaled \$400,000. Also, assume that the trust had accrued and unpaid debts, expenses, and taxes totaling \$300,000. Assume further that the entire \$300,000 represented amounts that would be deductible under section 2053 if the trust were includible in the transferor's gross estate. The numerator of the allocation fraction is \$100,000

and the denominator of the allocation fraction is \$200,000 $((\$400,000 - \$300,000) + \$100,000)$. Thus, the allocation fraction is .5 $(\$100,000 / \$200,000)$ and 50 percent of the value of future generation-skipping transfers will be subject to chapter 13.

EXAMPLE 3. *Multiple additions.* (i) Assume the same facts as in *Example 1*, except on January 30, 1988, when the total value of the entire trust is \$600,000, T transfers an additional \$40,000 to the trust. Before the transfer, the value of the portion of the trust that was attributable to the prior addition was \$120,000 $(\$600,000 \times .2)$. The new allocation fraction is computed as follows:

$$\frac{\text{Total value of additions}}{\text{Total value of trust}} = \frac{\$120,000 + \$40,000}{\$600,000 + \$40,000} = \frac{\$160,000}{\$640,000} = .25$$

(ii) Thus, immediately after the transfer, 25 percent of the value of future generation-skipping transfers under the trust will be subject to chapter 13.

EXAMPLE 4. *Allocation fraction at time of generation-skipping transfer.* Assume the same facts as in *Example 3*, except on March 1, 1989, when the value of the trust is \$800,000, C dies. A generation-skipping transfer occurs at C's death because of the termination of C's life estate. Therefore, \$200,000 $(\$800,000 \times .25)$ is subject to tax under chapter 13.

(v) **Constructive additions—(A) *Powers of Appointment.*** Except as provided in paragraph (b)(1)(v)(B) of this section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had

been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. See §26.2652-1 for rules for determining the identity of the transferor of property for purposes of chapter 13.

(B) ***Special rule for certain powers of appointment.*** The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) is not treated as an addition to a trust if—

(1) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under paragraph (b)(1) of this section; and

(2) In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or

power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period). For purposes of this paragraph (b)(1)(v)(B)(2), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(C) *Constructive addition if liability is not paid out of trust principal.* Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (e.g., when the right of recovery is no longer enforceable). But see §26.2652-1(a)(3) for rules involving the application of section 2207A in the case of an election under section 2652(a)(3).

(D) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(v):

EXAMPLE 1. *Lapse of a power of appointment.* On June 19, 1980, T established an irrevocable trust with a corpus of \$500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to T and S's grandchild, GC. T also gave S a general power of appointment over one-half of the trust assets. On December 21, 1989, when the value of the trust corpus is \$1,500,000, S died without having exercised the general power of appointment. The value of one-half of the trust corpus, \$750,000 ($\$1,500,000 \times .5$) is included in S's gross estate under section 2041(a) and is subject to tax under Chapter 11. Because the value of one-half of the trust corpus is subject to tax under Chapter 11 with respect to S's estate,

S is treated as the transferor of that property for purposes of Chapter 13 (see section 2652(a)(1)(A)). For purposes of the generation-skipping transfer tax, the lapse of S's power of appointment is treated as if \$750,000 ($\$1,500,000 \times .5$) had been distributed to S and then transferred back to the trust. Thus, S is considered to have added \$750,000 ($\$1,500,000 \times .5$) to the trust at the date of S's death. Because this constructive addition occurred after September 25, 1985, 50 percent of the corpus of the trust became subject to Chapter 13 at S's death.

EXAMPLE 2. *Multiple actual additions.* On June 19, 1980, T established an irrevocable trust with a principal of \$500,000. The trust instrument provides that the trustee shall distribute the entire income from the trust annually to T's spouse, S, during S's life. At S's death, the remainder is to be distributed to GC, the grandchild of T and S. On October 1, 1985, when the trust assets were valued at \$800,000, T added \$200,000 to the trust. After the transfer on October 1, 1985, the allocation fraction was .2 ($\$200,000/\$1,000,000$). On December 21, 1989, when the value of the trust principal is \$1,000,000, T adds \$1,000,000 to the trust. After this addition, the new allocation fraction is 0.6 ($\$1,200,000/\$2,000,000$). The numerator of the fraction is the value of that portion of trust assets that were subject to chapter 13 immediately prior to the addition (by reason of the first addition), \$200,000 ($.2 \times \$1,000,000$), plus the value of the second transfer, \$1,000,000, which equals \$1,200,000. The denominator of the fraction, \$2,000,000, is the total value of the trust assets immediately after the second transfer. Thus, 60 percent of the principal of the trust becomes subject to chapter 13.

EXAMPLE 3. *Entire portion of trust subject to lapsed power is treated as an addition.* On September 25, 1985, B possessed a general power of appointment over the assets of an irrevocable trust that had been created by T in 1980. Under the terms of the trust, B's power lapsed on July 20, 1987. For Federal gift tax purposes, B is treated as making a gift of ninety-five percent (100%—5%) of the value of the principal (see section 2514). However, because the entire trust was subject to the power of appointment, 100 percent (that portion of the trust subject to the power) of the assets of the trust are treated as a constructive addition. Thus, the entire amount of all generation-skipping transfers occurring pursuant to the trust instrument after July 20, 1987, are subject to chapter 13.

EXAMPLE 4. *Exercise of power of appointment in favor of another trust.* On March 1, 1985, T established an irrevocable trust as defined in paragraph (b)(1)(ii) of this section. Under the terms of the trust instrument, the trustee is required to distribute the entire income annually to T's child, C, for life, then to T's grandchild, GC, for life. GC has the power to appoint any or all of the trust assets to

Trust 2 which is an irrevocable trust (as defined in paragraph (b)(1)(ii) of this section) that was established on August 1, 1985. The terms of Trust 2's governing instrument provide that the trustee shall pay income to T's great grandchild, GGC, for life. Upon GGC's death, the remainder is to be paid to GGC's issue. GGC was alive on March 1, 1985, when Trust 1 was created. C died on April 1, 1986. On July 1, 1987, GC exercised the power of appointment. The exercise of GC's power does not subject future transfers from Trust 2 to tax under chapter 13 because the exercise of the power in favor of Trust 2 does not suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of creation of Trust 1, extending beyond the life of GGC (a beneficiary under Trust 2 who was in being at the date of creation of Trust 1) plus a period of 21 years. The result would be the same if Trust 2 had been created after the effective date of chapter 13.

EXAMPLE 5. Exercise of power of appointment in favor of another trust. Assume the same facts as in *Example 4*, except that GGC was born on March 28, 1986. The valid exercise of GC's power in favor of Trust 2 causes the principal of Trust 1 to be subject to chapter 13, because GGC was not born until after the creation of Trust 1. Thus, such exercise may suspend the vesting, absolute ownership, or power of alienation of an interest in the trust principal for a period, measured from the date of creation of Trust 1, extending beyond the life of GGC (a beneficiary under Trust 2 who was not a life in being at the date of creation of Trust 1).

EXAMPLE 6. Extension for the longer of two periods. Prior to the effective date of chapter 13, GP established an irrevocable trust under which the trust income was to be paid to GP's child, C, for life. C was given a testamentary power to appoint the remainder in further trust for the benefit of C's issue. In default of C's exercise of the power, the remainder was to pass to charity. C died on February 3, 1995, survived by a child who was alive when GP established the trust. C exercised the power in a manner that validly extends the trust in favor of C's issue until the latter of May 15, 2064 (80 years from the date the trust was created), or the death of C's child plus 21 years. C's exercise of the power is a constructive addition to the trust because the exercise may extend the trust for a period longer than the permissible periods of either the life of C's child (a life in being at the creation of the trust) plus 21 years or a term not more than 90 years measured from the creation of the trust. On the other hand, if C's exercise of the power could extend the trust based only on the life of C's child plus 21 years or only for a term of 80 years from the creation of the trust (but not the later of the two periods) then the exer-

cise of the power would not have been a constructive addition to the trust.

EXAMPLE 7. Extension for the longer of two periods. The facts are the same as in *Example 6* except local law provides that the effect of C's exercise is to extend the term of the trust until May 15, 2064, whether or not C's child predeceases that date by more than 21 years. C's exercise is not a constructive addition to the trust because C exercised the power in a manner that cannot postpone or suspend vesting, absolute ownership, or power of alienation for a term of years that will exceed 90 years. The result would be the same if the effect of C's exercise is either to extend the term of the trust until 21 years after the death of C's child or to extend the term of the trust until the first to occur of May 15, 2064 or 21 years after the death of C's child.

(vi) *Appreciation and income.* Except to the extent that the provisions of paragraphs (b)(1)(iv) and (v) of this section allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation in the value of the trust and undistributed income added thereto are not considered an addition to the principal of a trust.

(2) *Transition rule for wills or revocable trusts executed before October 22, 1986—(i) In general.* The provisions of chapter 13 do not apply to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986, provided that—

(A) The document in existence on October 21, 1986, is not amended at any time after October 21, 1986, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer;

(B) In the case of a revocable trust, no addition is made to the revocable trust after October 21, 1986, that results in the creation of, or an increase in the amount of, a generation-skipping transfer; and

(C) The decedent dies before January 1, 1987.

(ii) *Revocable trust defined.* For purposes of this section, the term *revocable trust* means any trust (as defined in section 2652(b)) except to the extent that, on October 22, 1986, the trust—

(A) Was an irrevocable trust described in paragraph (b)(1) of this section; or

(B) Would have been an irrevocable trust described in paragraph (b)(1) of

this section had it not been created or become irrevocable after September 25, 1985, and before October 22, 1986.

(iii) *Will or revocable trust containing qualified terminable interest property.* The rules contained in paragraph (b)(1)(iii) of this section apply to any will or revocable trust within the scope of the transition rule of this paragraph (b)(2).

(iv) *Amendments to will or revocable trust.* For purposes of this paragraph (b)(2), an amendment to a will or a revocable trust in existence on October 21, 1986, is not considered to result in the creation of, or an increase in the amount of, a generation-skipping transfer where the amendment is—

(A) Basically administrative or clarifying in nature and only incidentally increases the amount transferred; or

(B) Designed to ensure that an existing bequest or transfer qualifies for the applicable marital or charitable deduction for estate, gift, or generation-skipping transfer tax purposes and only incidentally increases the amount transferred to a skip person or to a generation-skipping trust.

(v) *Creation of, or increase in the amount of, a GST.* In determining whether a particular amendment to a will or revocable trust creates, or increases the amount of, a generation-skipping transfer for purposes of this paragraph (b)(2), the effect of the instrument(s) in existence on October 21, 1986, is measured against the effect of the instrument(s) in existence on the date of death of the decedent or on the date of any prior generation-skipping transfer. If the effect of an amendment cannot be immediately determined, it is deemed to create, or increase the amount of, a generation-skipping transfer until a determination can be made.

(vi) *Additions to revocable trusts.* Any addition made after October 21, 1986, but before the death of the settlor, to a revocable trust subjects all subsequent generation-skipping transfers under the trust to the provisions of chapter 13. Any addition made to a revocable trust after the death of the settlor (if the settlor dies before January 1, 1987) is treated as an addition to an irrevocable trust. See paragraph (b)(1)(v) of this section for rules involving con-

structive additions to trusts. See paragraph (b)(1)(v)(B) of this section for rules providing that certain transfers to trusts are not treated as additions for purposes of this section.

(vii) *Examples.* The following examples illustrate the application of paragraph (b)(2)(iv) of this section:

(A) *Facts applicable to Examples 1 through 5.* In each of *Examples 1 through 5* assume that T executed a will prior to October 22, 1986, and that T dies on December 31, 1986.

EXAMPLE 1. *Administrative change.* On November 1, 1986, T executes a codicil to T's will removing one of the co-executors named in the will. Although the codicil may have the effect of lowering administrative costs and thus increasing the amount transferred, it is considered administrative in nature and thus does not cause generation-skipping transfers under the will to be subject to chapter 13.

EXAMPLE 2. *Effect of amendment not immediately determinable.* On November 1, 1986, T executes a codicil to T's will revoking a bequest of \$100,000 to C, a non-skip person (as defined under section 2613(b)) and causing that amount to be added to a residuary trust held for a skip person. The amendment is deemed to increase the amount of a generation-skipping transfer and prevents any transfers under the will from qualifying under paragraph (b)(2)(i) of this section. If, however, C dies before T and under local law the property would have been added to the residue in any event because the bequest would have lapsed, the codicil is not considered an amendment that increases the amount of a generation-skipping transfer.

EXAMPLE 3. *Refund of tax paid because of amendment.* T's will provided that an amount equal to the maximum allowable marital deduction would pass to T's spouse with the residue of the estate passing to a trust established for the benefit of skip persons. On October 23, 1986, the will is amended to provide that the marital share passing to T's spouse shall be the lesser of the maximum allowable marital deduction or the minimum amount that will result in no estate tax liability for T's estate. The amendment may increase the amount of a generation-skipping transfer. Therefore, any generation-skipping transfers under the will are subject to tax under chapter 13. If it becomes apparent that the amendment does not increase the amount of a generation-skipping transfer, a claim for refund may be filed with respect to any generation-skipping transfer tax that was paid within the period set forth in section 6511. For example, it would become apparent that the amendment did not result in an increase

in the residue if it is subsequently determined that the maximum marital deduction and the minimum amount that will result in no estate tax liability are equal in amount.

EXAMPLE 4. *An amendment that increases a generation-skipping transfer causes complete loss of exempt status.* T's will provided for the creation of two trusts for the benefit of skip persons. On November 1, 1986, T executed a codicil to the will specifically increasing the amount of a generation-skipping transfer under the will. All transfers made pursuant to the will or either of the trusts created thereunder are precluded from qualifying under the transition rule of paragraph (b)(2)(i) of this section and are subject to tax under chapter 13.

EXAMPLE 5. *Corrective action effective.* Assume that T in Example 4 later executes a second codicil deleting the increase to the generation-skipping transfer. Because the provision increasing a generation-skipping transfer does not become effective, it is not considered an amendment to a will in existence on October 22, 1986.

(B) *Facts applicable to Examples 6 through 9.* T created a trust on September 30, 1985, in which T retained the power to revoke the transfer at any time prior to T's death. The trust provided that, upon the death of T, the income was to be paid to T's spouse, W, for life and then to A, B, and C, the children of T's sibling, S, in equal shares for life, with one-third of the principal to be distributed per stirpes to each child's surviving issue upon the death of the child. The trustee has the power to make discretionary distributions of trust principal to T's sibling, S.

EXAMPLE 6. *Amendment that affects only a person who is not a skip person.* A became disabled, and T modified the trust on December 1, 1986, to increase A's share of the income. Since the amendment does not result in the creation of, or increase in the amount of, a generation-skipping transfer, transfers pursuant to the trust are not subject to chapter 13.

EXAMPLE 7. *Amendment increasing skip person's share.* Assume that A, B, and C are the grandchildren of S rather than the children (and thus are skip persons as defined in section 2613). T's amendment of the trust increasing A's share of the income subjects the trust to the provisions of chapter 13 because the amendment increases the amount of the generation-skipping transfers to be made to A.

EXAMPLE 8. *Amendment that adds a skip person.* Assume that T amends the trust to add T's grandchild, D, as an income beneficiary. The trust will be subject to the provisions of

chapter 13 because the amendment creates a generation-skipping transfer.

EXAMPLE 9. *Refund of tax paid during interim period when effect of amendment is not determinable.* Assume that T amends the trust to provide that the issue of S are to take a one-fourth share of the principal per stirpes upon S's death. Because the distribution to be made upon S's death may involve skip persons, the amendment is considered an amendment that creates or increases the amount of a generation-skipping transfer until a determination can be made. Accordingly, any distributions from (or terminations of interests in) such trust are subject to chapter 13 until it is determined that no skip person has been added to the trust. At that time, a claim for refund may be filed within the period set forth in section 6511 with respect to any generation-skipping transfer tax that was paid.

(3) *Transition rule in the case of mental incompetency*—(i) *In general.* If an individual was under a mental disability to change the disposition of his or her property continuously from October 22, 1986, until the date of his or her death, the provisions of chapter 13 do not apply to any generation-skipping transfer—

(A) Under a trust (as defined in section 2652(b)) to the extent such trust consists of property, or the proceeds of property, the value of which was included in the gross estate of the individual (other than property transferred by or on behalf of the individual during the individual's life after October 22, 1986); or

(B) Which is a direct skip (other than a direct skip from a trust) that occurs by reason of the death of the individual.

(ii) *Mental disability defined.* For purposes of this paragraph (b)(2), the term *mental disability* means mental incompetence to execute an instrument governing the disposition of the individual's property, whether or not there was an adjudication of incompetence and regardless of whether there has been an appointment of a guardian, fiduciary, or other person charged with either the care of the individual or the care of the individual's property.

(iii)(A) *Decedent who has not been adjudged mentally incompetent.* If there has not been a court adjudication that the decedent was mentally incompetent on or before October 22, 1986, the executor must file, with Form 706, either—

(I) A certification from a qualified physician stating that the decedent was—

(i) Mentally incompetent at all times on and after October 22, 1986; and

(ii) Did not regain competence to modify or revoke the terms of the trust or will prior to his or her death; or

(2) Sufficient other evidence demonstrating that the decedent was mentally incompetent at all times on and after October 22, 1986, as well as a statement explaining why no certification is available from a physician; and

(3) Any judgement or decree relating to the decedent's incompetency that was made after October 22, 1986.

(B) Such items in paragraphs (b)(3)(iii)(A)(I), (2), and (3) of this section will be considered relevant, but not determinative, in establishing the decedent's state of competency.

(iv) *Decedent who has been adjudged mentally incompetent.* If the decedent has been adjudged mentally incompetent on or before October 22, 1986, a copy of the judgment or decree, and any modification thereof, must be filed with the Form 706.

(v) *Rule applies even if another person has power to change trust terms.* In the case of a transfer from a trust, this paragraph (b)(3) applies even though a person charged with the care of the decedent or the decedent's property has the power to revoke or modify the terms of the trust, provided that the power is not exercised after October 22, 1986, in a manner that creates, or increases the amount of, a generation-skipping transfer. See paragraph (b)(2)(iv) of this section for rules concerning amendments that create or increase the amount of a generation-skipping transfer.

(vi) *Example.* The following example illustrates the application of paragraph (b)(3)(v) of this section:

EXAMPLE. T was mentally incompetent on October 22, 1986, and remained so until death in 1993. Prior to becoming incompetent, T created a revocable generation-skipping trust that was includible in T's gross estate. Prior to October 22, 1986, the appropriate court issued an order under which P, who was thereby charged with the care of T's property, had the power to modify or revoke the revocable trust. Although P exercised the power after October 22, 1986, and while T

was incompetent, the power was not exercised in a manner that created, or increased the amount of, a generation-skipping transfer. Thus, the existence and exercise of P's power did not cause the trust to lose its exempt status under paragraph (b)(3) of this section. The result would be the same if the court order was issued after October 22, 1986.

(4) *Exceptions to additions rule*—(i) *In general.* Any addition to a trust made pursuant to an instrument or arrangement covered by the transition rules in paragraph (b) (1), (2) or (3) of this section is not treated as an addition for purposes of this section. Moreover, any property transferred inter vivos to a trust is not treated as an addition if the same property would have been added to the trust pursuant to an instrument covered by the transition rules in paragraph (b) (2) or (3) of this section.

(ii) *Examples.* The following examples illustrate the application of paragraph (b)(4)(i) of this section:

EXAMPLE 1. *Addition pursuant to terms of exempt instrument.* On December 31, 1980, T created an irrevocable trust having a principal of \$100,000. Under the terms of the trust, the principal was to be held for the benefit of T's grandchild, GC. Pursuant to the terms of T's will, a document entitled to relief under the transition rule of paragraph (b)(2) of this section, the residue of the estate was paid to the trust. Because the addition to the trust was paid pursuant to the terms of an instrument (T's will) that is not subject to the provisions of chapter 13 because of paragraph (b)(2) of this section, the payment to the trust is not considered an addition to the principal of the trust. Thus, distributions to or for the benefit of GC, are not subject to the provisions of chapter 13.

EXAMPLE 2. *Property transferred inter vivos that would have been transferred to the same trust by the transferor's will.* T is the grantor of a trust that was irrevocable on September 25, 1985. T's will, which was executed before October 22, 1986, and not amended thereafter, provides that, upon T's death, the entire estate will pour over into T's trust. On October 1, 1985, T transfers \$100,000 to the trust. While T's will otherwise qualifies for relief under the transition rule in paragraph (b)(2) of this section, the transition rule is not applicable unless T dies prior to January 1, 1987. Thus, if T dies after December 31, 1986, the transfer is treated as an addition to the trust for purposes of any distribution made from the trust after the transfer to the trust on October 1, 1985. If T dies before January 1, 1987, the entire trust (as well as any distributions from or terminations of interests in

the trust prior to T's death) is exempt, under paragraph (b)(2) of this section, from chapter 13 because the \$100,000 would have been added to the trust under a will that would have qualified under paragraph (b)(2) of this section. In either case, for any generation-skipping transfers made after the transfer to the trust on October 1, 1985, but before T's death, the \$100,000 is treated as an addition to the trust and a proportionate amount of the trust is subject to chapter 13.

EXAMPLE 3. *Pour over to a revocable trust.* T and S are the settlors of separate revocable trusts with equal values. Both trusts were established for the benefit of skip persons (as defined in section 2613). S dies on December 1, 1985, and under the provisions of S's trust, the principal pours over into T's trust. If T dies before January 1, 1987, the entire trust is excluded under paragraph (b)(2) of this section from the operation of chapter 13. If T dies after December 31, 1986, the entire trust is subject to the generation-skipping transfer tax provisions because T's trust is not a trust described in paragraph (b)(1) or (2) of this section. In the latter case, the fact that S died before January 1, 1987, is irrelevant because the principal of S's trust was added to a trust that never qualified under the transition rules of paragraph (b)(1) or (2) of this section.

EXAMPLE 4. *Pour over to exempt trust.* Assume the same facts as in *Example 3*, except upon the death of S on December 1, 1985, S's trust continues as an irrevocable trust and that the principal of T's trust is to be paid over upon T's death to S's trust. Again, if T dies before January 1, 1987, S's entire trust falls within the provisions of paragraph (b)(2) of this section. However, if T dies after December 31, 1986, the pour-over is considered an addition to the trust. Therefore, S's trust is not a trust excluded under paragraph (b)(2) of this section because an addition is made to the trust.

EXAMPLE 5. *Lapse of a general power of appointment.* S, the spouse of the settlor of an irrevocable trust that was created in 1980, had, on September 25, 1985, a general power of appointment over the trust assets. The trust provides that should S fail to exercise the power of appointment the property is to remain in the trust. On October 21, 1986, S executed a will under which S failed to exercise the power of appointment. If S dies before January 1, 1987, without having exercised the power in a manner which results in the creation of, or increase in the amount of, a generation-skipping transfer (or amended the will in a manner that results in the creation of, or increase in the amount of, a generation-skipping transfer), transfers pursuant to the trust or the will are not subject to chapter 13 because the trust is an irrevocable trust and the will qualifies under paragraph (b)(2) of this section.

EXAMPLE 6. *Lapse of general power of appointment held by intestate decedent.* Assume the same facts as in *Example 5*, except on October 22, 1986, S did not have a will and that S dies after that date. Upon S's death, or upon the prior exercise or release of the power, the value of the entire trust is treated as having been distributed to S, and S is treated as having made an addition to the trust in the amount of the entire principal. Any distribution or termination pursuant to the trust occurring after S's death is subject to chapter 13. It is immaterial whether S's death occurs before January 1, 1987, since paragraph (b)(2) of this section is only applicable where a will or revocable trust was executed before October 22, 1986.

(c) ***Additional effective dates.*** Except as otherwise provided, the regulations under §§ 26.2611-1, 26.2612-1, 26.2613-1, 26.2632-1, 26.2641-1, 26.2642-1, 26.2642-2, 26.2642-3, 26.2642-4, 26.2642-5, 26.2652-1, 26.2652-2, 26.2653-1, 26.2654-1, 26.2663-1, and 26.2663-2 are effective with respect to generation-skipping transfers as defined in § 26.2611-1 made on or after December 27, 1995. However, taxpayers may, at their option, rely on these regulations in the case of generation-skipping transfers made, and trusts that became irrevocable, after December 23, 1992, and before December 27, 1995.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29653, June 12, 1996, as amended at 61 FR 43656, Aug. 26, 1996]

§ 26.2611-1 Generation-skipping transfer defined.

A generation-skipping transfer (GST) is an event that is either a direct skip, a taxable distribution, or a taxable termination. See § 26.2612-1 for the definition of these terms. The determination as to whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax. See § 26.2652-1(a)(2) for determining whether a transfer is subject to Federal estate or gift tax.

§ 26.2612-1 Definitions.

(a) ***Direct skip***—(1) ***In general.*** A direct skip is a transfer to a skip person that is subject to Federal estate or gift tax. If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person. Only one direct skip occurs when a single transfer of property skips two or more generations. See paragraph (d) of this section

for the definition of skip person. See § 26.2652-1(b) for the definition of trust. See § 26.2632-1(c)(4) for the time that a direct skip occurs if the transferred property is subject to an estate tax inclusion period.

(2) *Special rule for certain lineal descendants*—(i) *In general.* Solely for the purpose of determining whether a transfer to or for the benefit of a lineal descendant of the transferor, the transferor's spouse, or a former spouse of the transferor is a direct skip, the generation assignment of the descendant is determined by disregarding the generation of a predeceased individual who was both an ancestor of the descendant and a lineal descendant of the transferor, the transferor's spouse, or a former spouse of the transferor (a predeceased child). If a transfer to a trust would be a direct skip but for this paragraph, any generation assignment determined under this paragraph continues to apply in determining whether any subsequent distribution from (or termination of an interest in) the portion of the trust attributable to that transfer is a GST. A living descendant who dies no later than 90 days after the subject transfer is treated as having predeceased the transferor to the extent that either the governing instrument or applicable local law provides that such individual shall be treated as predeceasing the transferor. Except as provided in this paragraph (a)(2), a living descendant is not treated as a predeceased child solely by reason of applicable local law; e.g., an individual is not treated as a predeceased child solely because state law treats an individual executing a disclaimer as having predeceased the transferor of the disclaimed property. See § 26.2652-1(a)(1) for the definition of *transferor*. See paragraph (e) of this section for the definition of *interest in trust*.

(ii) *Special rule.* If a transferor makes an addition to an existing trust after the death of an individual described in paragraph (a)(2)(i) of this section (so that the lineal descendant would be assigned to a higher generation by reason of that death), the additional property is treated as being held in a separate trust for purposes of chapter 13 and the provisions of § 26.2654-1(a)(2) apply as if the portions of the single trust had sep-

arate transferors. Subsequent additions are treated as additions to the appropriate portion of the single trust.

(b) *Taxable termination*—(1) *In general.* Except as otherwise provided in this paragraph (b), a taxable termination is a termination (occurring for any reason) of an interest in trust unless—

(i) A transfer subject to Federal estate or gift tax occurs with respect to the property held in the trust at the time of the termination;

(ii) Immediately after the termination, a person who is not a skip person has an interest in the trust; or

(iii) At no time after the termination may a distribution, other than a distribution the probability of which occurring is so remote as to be negligible (including a distribution at the termination of the trust) be made from the trust to a skip person. For this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur.

(2) *Partial termination.* If a distribution of a portion of trust property is made to a skip person by reason of a termination occurring on the death of a lineal descendant of the transferor, the termination is a taxable termination with respect to the distributed property.

(3) *Simultaneous terminations.* A simultaneous termination of two or more interests creates only one taxable termination.

(c) *Taxable distribution*—(1) *In general.* A taxable distribution is a distribution of income or principal from a trust to a skip person unless the distribution is a taxable termination or a direct skip. If any portion of GST tax (including penalties and interest thereon) imposed on a distributee is paid from the distributing trust, the payment is an additional taxable distribution to the distributee. For purposes of chapter 13, the additional distribution is treated as having been made on the last day of the calendar year in which the original taxable distribution is made. If Federal estate or gift tax is imposed on any individual with respect to an interest in property held by a trust, the interest in

property is treated as having been distributed to the individual to the extent that the value of the interest is subject to Federal estate or gift tax. See § 26.2652-1(a)(6) *Example 5*, regarding the treatment of the lapse of a power of appointment as a transfer to a trust.

(2) *Look-through rule not to apply.* Solely for purposes of determining whether any transfer from a trust to another trust is a taxable distribution, the rules of section 2651(e)(2) do not apply. If the transferring trust and the recipient trust have the same transferor, see § 26.2642-4(a) (1) and (2) for rules for recomputing the applicable fraction of the recipient trust.

(d) *Skip person.* A skip person is—

(1) An individual assigned to a generation more than one generation below that of the transferor (determined under the rules of section 2651); or

(2) A trust if—

(i) All interests in the trust are held by skip persons; or

(ii) No person holds an interest in the trust and no distributions, other than a distribution the probability of which occurring is so remote as to be negligible (including distributions at the termination of the trust), may be made after the transfer to a person other than a skip person. For this purpose, the probability that a distribution will occur is so remote as to be negligible only if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur.

(e) *Interest in trust—*(1) *In general.* An interest in trust is an interest in property held in trust as defined in section 2652(c) and these regulations. An interest in trust exists if a person—

(i) Has a present right to receive trust principal or income;

(ii) Is a permissible current recipient of trust principal or income and is not described in section 2055(a); or

(iii) Is described in section 2055(a) and the trust is a charitable remainder annuity trust or unitrust (as defined in section 664(d)) or a pooled income fund (as defined in section 642(c)(5)).

(2) *Exceptions—*(i) *Support obligations.* In general, an individual has a present right to receive trust income or principal if trust income or principal may

be used to satisfy the individual's support obligations. However, an individual does not have an interest in a trust merely because a support obligation of that individual may be satisfied by a distribution that is either within the discretion of a fiduciary or pursuant to provisions of local law substantially equivalent to the Uniform Gifts (Transfers) to Minors Act.

(ii) *Certain interests disregarded.* An interest which is used primarily to postpone or avoid the GST tax is disregarded for purposes of chapter 13. An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax.

(3) *Disclaimers.* An interest does not exist to the extent it is disclaimed pursuant to a disclaimer that constitutes a qualified disclaimer under section 2518.

(f) *Examples.* The following examples illustrate the provisions of this section. Unless stated otherwise, paragraph (a)(2) of this section, which assigns descendants to a higher generation when there is a predeceased ancestor, does not apply.

EXAMPLE 1. *Direct skip.* T gratuitously conveys Blackacre to T's grandchild. Because the transfer is a transfer to a skip person of property subject to Federal gift tax, it is a direct skip.

EXAMPLE 2. *Direct skip of more than one generation.* T gratuitously conveys Blackacre to T's great-grandchild. The transfer is a direct skip. Only one GST tax is imposed on the direct skip although two generations are skipped by the transfer.

EXAMPLE 3. *Withdrawal power in trust.* T transfers \$50,000 to a new trust providing that trust income is to be paid to T's child, C, for life and, on C's death, the trust principal is to be paid to T's descendants. Under the terms of the trust, T grants four grandchildren the right to withdraw \$10,000 from the trust for a 60 day period following the transfer. Since C, who is not a skip person, has an interest in the trust, the trust is not a skip person. T's transfer to the trust is not a direct skip.

EXAMPLE 4. *Taxable termination.* T establishes an irrevocable trust under which the income is to be paid to T's child, C, for life. On the death of C, the trust principal is to be paid to T's grandchild, GC. Since C has an interest in the trust, the trust is not a skip person and the transfer to the trust is not a

direct skip. If C dies survived by GC, a taxable termination occurs at C's death because C's interest in the trust terminates and thereafter the trust property is held by a skip person who occupies a lower generation than C.

EXAMPLE 5. *Direct skip of property held in trust.* T establishes a testamentary trust under which the income is to be paid to T's surviving spouse, S, for life and the remainder is to be paid to a grandchild of T and S. T's executor elects to treat the trust as qualified terminable interest property under section 2056(b)(7). The transfer to the trust is not a direct skip because S, a person who is not a skip person, holds a present right to receive income from the trust. Upon S's death, the trust property is included in S's gross estate under section 2044 and passes directly to a skip person. The GST occurring at that time is a direct skip because it is a transfer subject to chapter 11. The fact that the interest created by T is terminated at S's death is immaterial because S becomes the transferor at the time of the transfer subject to chapter 11.

EXAMPLE 6. *Predeceased ancestor exception.* T establishes an irrevocable trust providing that trust income is to be paid to T's grandchild, GC, for 5 years. At the end of the 5-year period, the trust is to terminate and the principal is to be distributed to GC. T's child, C, a parent of GC, is deceased at the time T establishes the trust. Therefore, GC is treated as a child of T rather than as a grandchild. As a result, GC is not a skip person, and the initial transfer to the trust is not a direct skip. Similarly, distributions to GC during the term of the trust and at the termination of the trust will not be GSTs.

EXAMPLE 7. *Predeceased ancestor exception not applicable.* The facts are the same as in *Example 6*, except the trust income is to be paid to T's spouse, S, during the first two years of the trust. Since S has an interest in the trust, the trust is not a skip person and the transfer by T is not a direct skip. Since the transfer is not a direct skip, the predeceased ancestor rule does not apply and GC is not treated as the child of T. A taxable termination occurs at the expiration of S's interest.

EXAMPLE 8. *Taxable termination.* T establishes an irrevocable trust for the benefit of T's child, C, T's grandchild, GC, and T's great-grandchild, GGC. Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the discretion of the trustee. Upon the death of the second beneficiary to die, the trust principal is to be paid to the survivor. C dies first. A taxable termination occurs at that time because, immediately after C's interest terminates, all interests in the trust are held by skip persons (GC and GGC).

EXAMPLE 9. *Taxable termination resulting from distribution.* The facts are the same as in *Example 8*, except twenty years after C's death the trustee exercises its discretionary power and distributes the entire principal to GGC. The distribution results in a taxable termination because GC's interest in the trust terminates as a result of the distribution of the entire trust property to GGC, a skip person. The result would be the same if the trustee retained sufficient funds to pay the GST tax due by reason of the taxable termination, as well as any expenses of winding up the trust.

EXAMPLE 10. *Simultaneous termination of interests of more than one beneficiary.* T establishes an irrevocable trust for the benefit of T's child, C, T's grandchild, GC, and T's great-grandchild, GGC. Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the discretion of the trustee. Upon the death of C, the trust property is to be distributed to GGC if then living. If C is survived by both GC and GGC, both C's and GC's interests in the trust will terminate on C's death. However, because both interests will terminate at the same time and as a result of one event, only one taxable termination occurs.

EXAMPLE 11. *Partial taxable termination.* T creates an irrevocable trust providing that trust income is to be paid to T's children, A and B, in such proportions as the trustee determines for their joint lives. On the death of the first child to die, one-half of the trust principal is to be paid to T's then living grandchildren. The balance of the trust principal is to be paid to T's grandchildren on the death of the survivor of A and B. If A predeceases B, the distribution occurring on the termination of A's interest in the trust is a taxable termination and not a taxable distribution. It is a taxable termination because the distribution is a distribution of a portion of the trust that occurs as a result of the death of A, a lineal descendant of T. It is immaterial that a portion of the trust continues and that B, a person other than a skip person, thereafter holds an interest in the trust.

EXAMPLE 12. *Taxable distribution.* T establishes an irrevocable trust under which the trust income is payable to T's child, C, for life. When T's grandchild, GC, attains 35 years of age, GC is to receive one-half of the principal. The remaining one-half of the principal is to be distributed to GC on C's death. Assume that C survives until GC attains age 35. When the trustee distributes one-half of the principal to GC on GC's 35th birthday, the distribution is a taxable distribution because it is a distribution to a skip person and is neither a taxable termination nor a direct skip.

EXAMPLE 13. *Exercise of withdrawal right as taxable distribution.* The facts are the same as

in *Example 12*, except GC holds a continuing right to withdraw trust principal and after one year GC withdraws \$10,000. The withdrawal by GC is not a taxable termination because the withdrawal does not terminate C's interest in the trust. The withdrawal by GC is a taxable distribution to GC.

EXAMPLE 14. *Interest in trust.* T establishes an irrevocable trust under which the income is to be paid to T's child, C, for life. On the death of C, the trust principal is to be paid to T's grandchild, GC. Because C has a present right to receive income from the trust, C has an interest in the trust. Because GC cannot currently receive distributions from the trust, GC does not have an interest in the trust.

EXAMPLE 15. *Support obligation.* T establishes an irrevocable trust for the benefit of T's grandchild, GC. The trustee has discretion to distribute property for GC's support without regard to the duty or ability of GC's parent, C, to support GC. Because GC is a permissible current recipient of trust property, GC has an interest in the trust. C does not have an interest in the trust because the potential use of the trust property to satisfy C's support obligation is within the discretion of a fiduciary. C would be treated as having an interest in the trust if the trustee was required to distribute trust property for GC's support.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29653, June 12, 1996]

§ 26.2613-1 Skip person.

For the definition of *skip person* see § 26.2612-1(d).

§ 26.2632-1 Allocation of GST exemption.

(a) *General rule.* Except as otherwise provided in this section, an individual or the individual's executor may allocate the individual's \$1 million GST exemption at any time from the date of the transfer through the date for filing the individual's Federal estate tax return (including any extensions for filing that have been actually granted). If no estate tax return is required to be filed, the GST exemption may be allocated at any time through the date a Federal estate tax return would be due if a return were required to be filed (including any extensions actually granted). If property is held in trust, the allocation of GST exemption is made to the entire trust rather than to specific trust assets. If a transfer is a direct skip to a trust, the allocation of GST exemption to the transferred property

is also treated as an allocation of GST exemption to the trust for purposes of future GSTs with respect to the trust by the same transferor.

(b) *Lifetime allocations—*(1) *Automatic allocation to direct skips—*(i) *In general.* If a direct skip occurs during the transferor's lifetime, the transferor's GST exemption not previously allocated (unused GST exemption) is automatically allocated to the transferred property (but not in excess of the fair market value of the property on the date of the transfer). The transferor may prevent the automatic allocation of GST exemption by describing on a timely-filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) the transfer and the extent to which the automatic allocation is not to apply. In addition, a timely-filed Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip) is sufficient to prevent an automatic allocation of GST exemption with respect to the transferred property. See paragraph (c)(4) of this section for special rules in the case of direct skips treated as occurring at the termination of an estate tax inclusion period.

(ii) *Time for filing Form 709.* A Form 709 is timely filed if it is filed on or before the date required for reporting the transfer if it were a taxable gift (i.e., the date prescribed by section 6075(b), including any extensions to file actually granted (the due date)). Except as provided in paragraph (b)(1)(iii) of this section, the automatic allocation of GST exemption (or the election to prevent the allocation, if made) is irrevocable after the due date. An automatic allocation of GST exemption is effective as of the date of the transfer to which it relates. Except as provided above, a Form 709 need not be filed to report an automatic allocation.

(iii) *Transitional rule.* An election to prevent an automatic allocation of GST exemption filed on or before January 26, 1996, becomes irrevocable on July 24, 1996.

(2) *Allocation to other transfers—*(i) *In general.* An allocation of GST exemption to property transferred during the transferor's lifetime, other than in a direct skip, is made on Form 709. The allocation must clearly identify the

trust to which the allocation is being made, the amount of GST exemption allocated to it, and if the allocation is late or if an inclusion ratio greater than zero is claimed, the value of the trust assets at the effective date of the allocation. See paragraph (b)(2)(ii) of this section. The allocation should also state the inclusion ratio of the trust after the allocation. Except as otherwise provided in this paragraph, an allocation of GST exemption may be made by a formula; e.g., the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero. However, formula allocations made with respect to charitable lead annuity trusts are not valid except to the extent they are dependent on values as finally determined for Federal estate or gift tax purposes. With respect to a timely allocation, an allocation of GST exemption becomes irrevocable after the due date of the return. Except as provided in § 26.2642-3 (relating to charitable lead annuity trusts), an allocation of GST exemption to a trust is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust. See § 26.2642-1 for the definition of inclusion ratio. An allocation is also void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation. For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible.

(ii) *Effective date of allocation*—(A) *In general.* (1) Except as otherwise provided, an allocation of GST exemption is effective as of the date of any transfer as to which the Form 709 on which it is made is a timely filed return (a timely allocation). If more than one timely allocation is made, the earlier allocation is modified only if the later allocation clearly identifies the transfer and the nature and extent of the modification. Except as provided in paragraph (d)(1) of this section, an allocation to a trust made on a Form 709 filed after the due date for reporting a transfer to the trust (a late allocation) is effective on the date the Form 709 is filed and is deemed to precede in point of time any taxable event occurring on

such date. For purposes of this paragraph (b)(2)(ii), the Form 709 is deemed filed on the date it is postmarked to the Internal Revenue Service Center. See § 26.2642-2 regarding the effect of a late allocation in determining the inclusion ratio, etc. See paragraph (c)(1) of this section regarding allocation of GST exemption to property subject to an estate tax inclusion period. If it is unclear whether an allocation of GST exemption on a Form 709 is a late or a timely allocation to a trust, the allocation is effective in the following order—

(i) To any transfer to the trust disclosed on the return as to which the return is a timely return;

(ii) As a late allocation; and

(iii) To any transfer to the trust not disclosed on the return as to which the return would be a timely return.

(2) A late allocation to a trust may be made on a Form 709 that is timely filed with respect to another transfer. A late allocation is irrevocable when made.

(B) *Amount of allocation.* If other transfers exist with respect to which GST exemption could be allocated under paragraphs (b)(2)(ii)(A)(i) (i) and (iii), any GST exemption allocated under paragraph (b)(2)(ii)(A)(i) (i) of this section is allocated in an amount equal to the value of the transferred property as reported on the Form 709. Thus, if the GST exemption allocated on the Form 709 exceeds the value of the transfers reported on that return that have generation-skipping potential, the initial allocation under paragraph (b)(2)(ii)(A)(i) (i) of this section is in the amount of the value of those transfers as reported on that return. Any remaining amount of GST exemption allocated on that return is then allocated pursuant to paragraphs (b)(2)(ii)(A)(i) (i) and (iii) of this section, notwithstanding any subsequent upward adjustment in value of the transfers reported on the return.

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (b):

EXAMPLE 1. *Modification of allocation of GST exemption.* T transfers \$100,000 to an irrevocable generation-skipping trust on December 1, 1996. The transfer to the trust is not a direct skip. The date prescribed for filing the

gift tax return reporting the taxable gift is April 15, 1997. On February 10, 1997, T files a Form 709 allocating \$50,000 of GST exemption to the trust. On April 10 of the same year, T files an amended Form 709 allocating \$100,000 of GST exemption to the trust in a manner that clearly indicates the intention to modify and supersede the prior allocation with respect to the 1996 transfer. The allocation made on the April 10 return supersedes the prior allocation because it is made on a timely-filed Form 709 that clearly identifies the trust and the nature and extent of the modification of GST exemption allocation. The allocation of \$100,000 of GST exemption to the trust is effective as of December 1, 1996. The result would be the same if the amended Form 709 decreased the amount of the GST exemption allocated to the trust.

EXAMPLE 2. *Modification of allocation of GST exemption.* The facts are the same as in *Example 1*, except on July 10, 1997, T files a Form 709 attempting to reduce the earlier allocation. The return is not a timely-filed return. The \$100,000 GST exemption allocated to the trust, as amended on April 10, 1997, remains in effect because an allocation, once made, is irrevocable and may not be modified after the last date on which a timely-filed Form 709 can be filed.

EXAMPLE 3. *Effective date of late allocation of GST exemption.* T transfers \$100,000 to an irrevocable generation-skipping trust on December 1, 1996. The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 1997. On December 1, 1997, T files a Form 709 and allocates \$50,000 to the trust. The allocation is effective as of December 1, 1997.

EXAMPLE 4. *Effective date of late allocation of GST exemption.* T transfers \$100,000 to a generation-skipping trust on December 1, 1996, in a transfer that is not a direct skip. T does not make an allocation of GST exemption on a timely-filed Form 709. On July 1, 1997, the trustee makes a taxable distribution from the trust to T's grandchild in the amount of \$30,000. Immediately prior to the distribution, the value of the trust assets was \$150,000. On the same date, T allocates GST exemption to the trust in the amount of \$50,000. The allocation of GST exemption on the date of the transfer is treated as preceding in point of time the taxable distribution. At the time of the GST, the trust has an inclusion ratio of .6667 ($1 - (50,000/150,000)$).

EXAMPLE 5. *Automatic allocation to split-gift direct skip.* On May 15, 1996, T transfers \$50,000 to a trust in a direct skip. T does not file a timely gift tax return electing out of the automatic allocation. On April 30, 1998, T and T's spouse, S, file an initial gift tax return for 1996 on which they consent, pursuant to section 2513, to have the gift treated as if one-half had been made by each. As a

result of the election under section 2513, which is retroactive to the date of T's transfer, T and S are each treated as the transferor of one-half of the property transferred in the direct skip. Thus, \$25,000 of T's unused GST exemption and \$25,000 of S's unused GST exemption is automatically allocated to the trust. Both allocations are effective on and after the date that T made the transfer.

(c) *Special rules during an estate tax inclusion period—*(1) *In general.* An allocation of GST exemption (including an automatic allocation) to property subject to an estate tax inclusion period (ETIP) that is made prior to termination of the ETIP cannot be revoked, but becomes effective no earlier than the date of any termination of the ETIP with respect to the trust. Where an allocation has not been made prior to the termination of the ETIP, an allocation is effective at the termination of the ETIP during the transferor's lifetime if made by the due date for filing a Form 709 that would apply to a taxable gift occurring at the time the ETIP terminates (timely ETIP return). An allocation is effective in the case of the termination of the ETIP on the death of the transferor as provided in paragraph (d) of this section. If any part of a trust is subject to an ETIP, the entire trust is subject to the ETIP. See § 26.2642-1(b)(2) for rules determining the inclusion ratio applicable in the case of GSTs during an ETIP.

(2) *Estate tax inclusion period defined—*(i) *In general.* An ETIP is the period during which, should death occur, the value of transferred property would be includible (other than by reason of section 2035) in the gross estate of—

- (A) The transferor; or
- (B) The spouse of the transferor.

(ii) *Exceptions—*(A) For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate.

(B) For purposes of paragraph (c)(2) of this section, the value of transferred

property is not considered as being subject to inclusion in the gross estate of the spouse of the transferor, if the spouse possesses with respect to any transfer to the trust, a right to withdraw no more than the greater of \$5,000 or 5 percent of the trust corpus, and such withdrawal right terminates no later than 60 days after the transfer to the trust.

(C) The rules of this paragraph (c)(2) do not apply to qualified terminable interest property with respect to which the special election under § 26.2652-2 has been made.

(3) *Termination of an ETIP.* An ETIP terminates on the first to occur of—

(i) The death of the transferor;
 (ii) The time at which no portion of the property is includible in the transferor's gross estate (other than by reason of section 2035) or, in the case of an individual who is a transferor solely by reason of an election under section 2513, the time at which no portion would be includible in the gross estate of the individual's spouse (other than by reason of section 2035);

(iii) The time of a GST, but only with respect to the property involved in the GST; or

(iv) In the case of an ETIP arising by reason of an interest or power held by the transferor's spouse under subsection (c)(2)(i)(B) of this section, at the first to occur of—

(A) The death of the spouse; or
 (B) The time at which no portion of the property would be includible in the spouse's gross estate (other than by reason of section 2035).

(4) *Treatment of direct skips.* If property transferred to a skip person is subject to an ETIP, the direct skip is treated as occurring on the termination of the ETIP.

(5) *Examples.* The following examples illustrate the rules of this section as they apply to the termination of an ETIP during the lifetime of the transferor. In each example assume that T transfers \$100,000 to an irrevocable trust:

EXAMPLE 1. Allocation of GST exemption during ETIP. The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. If T dies within the 9-year period, the value of the trust

principal is includible in T's gross estate under section 2036(a). Thus, the trust is subject to an ETIP. T files a timely Form 709 reporting the transfer and allocating \$100,000 of GST exemption to the trust. The allocation of GST exemption to the trust is not effective until the termination of the ETIP.

EXAMPLE 2. Effect of prior allocation on termination of ETIP. The facts are the same as in *Example 1*, except the trustee has the power to invade trust principal on behalf of T's grandchild, GC, during the term of T's income interest. In year 4, when the value of the trust is \$200,000, the trustee distributes \$15,000 to GC. The distribution is a taxable distribution. The ETIP with respect to the property distributed to GC terminates at the time of the taxable distribution. See paragraph (c)(3)(iii) of this section. Solely for purposes of determining the trust's inclusion ratio with respect to the taxable distribution, the prior \$100,000 allocation of GST exemption (as well as any additional allocation made on a timely ETIP return) is effective immediately prior to the taxable distribution. See § 26.2642-1(b)(2). The trust's inclusion ratio with respect to the taxable distribution is therefore .50 ($1 - (100,000/200,000)$).

EXAMPLE 3. Split-gift transfers subject to ETIP. The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. T files a timely Form 709 reporting the transfer. T's spouse, S, consents to have the gift treated as made one-half by S under section 2513. Because S is treated as transferring one-half of the property to T's grandchild, S becomes the transferor of one-half of the trust for purposes of chapter 13. Because the value of the trust would be includible in T's gross estate if T died immediately after the transfer, S's transfer is subject to an ETIP. If S should die prior to the termination of the trust, S's executor may allocate S's GST exemption to the trust, but only to the portion of the trust for which S is treated as the transferor. However, the allocation does not become effective until the earlier of the expiration of T's income interest or T's death.

EXAMPLE 4. Transfer of retained interest as ETIP termination. The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. Four years after the initial transfer, T transfers the income interest to T's sibling. The ETIP with respect to the trust terminates on T's transfer of the income interest because, after the transfer, the trust property would not be includible in T's gross estate (other than by reason of section 2035) if T died at that time.

(d) *Allocations after the transferor's death—(1) Allocation by executor.* Except

as otherwise provided in this paragraph (d), an allocation of a decedent's unused GST exemption by the executor of the decedent's estate is made on the appropriate United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706 or Form 706NA) filed on or before the date prescribed for filing the return by section 6075(a) (including any extensions actually granted (the due date)). An allocation of GST exemption with respect to property included in the gross estate of a decedent is effective as of the date of death. A timely allocation of GST exemption by an executor with respect to a lifetime transfer of property that is not included in the transferor's gross estate is made on a Form 709. A late allocation of GST exemption by an executor, other than an allocation that is deemed to be made under section 2632(b)(1), with respect to a lifetime transfer of property is made on Form 706, Form 706NA or Form 709 (filed on or before the due date of the transferor's estate tax return) and is effective as of the date the allocation is filed. An allocation of GST exemption to a trust (whether or not funded at the time the Form 706 or Form 706NA is filed) is effective if the notice of allocation clearly identifies the trust and the amount of the decedent's GST exemption allocated to the trust. An executor may allocate the decedent's GST exemption by use of a formula. For purposes of this section, an allocation is void if the allocation is made for a trust that has no GST potential with respect to the transferor for whom the allocation is being made, as of the date of the transferor's death. For this purpose, a trust has GST potential even if the possibility of a GST is so remote as to be negligible.

(2) *Automatic allocation after death.* A decedent's unused GST exemption is automatically allocated on the due date for filing Form 706 or Form 706NA to the extent not otherwise allocated by the decedent's executor on or before that date. The automatic allocation occurs whether or not a return is actually required to be filed. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)), on the basis of the value of the property as finally determined for purposes of chap-

ter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. The automatic allocation of GST exemption is irrevocable, and an allocation made by the executor after the automatic allocation is made is ineffective. No automatic allocation of GST exemption is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust. In addition, no automatic allocation of GST exemption is made to a trust if, during the nine month period ending immediately after the death of the transferor—

(i) No GST has occurred with respect to the trust; and

(ii) At the end of such period no future GST can occur with respect to the trust.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

§ 26.2641-1 Applicable rate of tax.

The rate of tax applicable to any GST (applicable rate) is determined by multiplying the maximum Federal estate tax rate in effect at the time of the GST by the inclusion ratio (as defined in § 26.2642-1). For this purpose, the maximum Federal estate tax rate is the maximum rate set forth under section 2001(c) (without regard to section 2001(c)(2)).

§ 26.2642-1 Inclusion ratio.

(a) *In general.* Except as otherwise provided in this section, the inclusion ratio is determined by subtracting the applicable fraction (rounded to the nearest one-thousandth (.001)) from 1. In rounding the applicable fraction to the nearest one-thousandth, any amount that is midway between one

one-thousandth and another one-thousandth is rounded up to the higher of those two amounts.

(b) *Numerator of applicable fraction—*

(1) *In general.* Except as otherwise provided in this paragraph (b), and in §§ 26.2642-3 (providing a special rule for charitable lead annuity trusts) and 26.2642-4 (providing rules for the retermination of the applicable fraction), the numerator of the applicable fraction is the amount of GST exemption allocated to the trust (or to the transferred property in the case of a direct skip not in trust).

(2) *GSTs occurring during an ETIP—*(i) *In general.* For purposes of determining the inclusion ratio with respect to a taxable termination or a taxable distribution that occurs during an ETIP, the numerator of the applicable fraction is the sum of—

(A) The GST exemption previously allocated to the trust (including any allocation made to the trust prior to any taxable termination or distribution) reduced (but not below zero) by the nontax amount of any prior GSTs with respect to the trust; and

(B) Any GST exemption allocated to the trust on a timely ETIP return filed after the termination of the ETIP. See § 26.2632-1(c)(5) *Example 2*.

(ii) *Nontax amount of a prior GST.* (1) The nontax amount of a prior GST with respect to the trust is the amount of the GST multiplied by the applicable fraction attributable to the trust at the time of the prior GST.

(2) For rules regarding the allocation of GST exemption to property during an ETIP, see § 26.2632-1(c).

(c) *Denominator of applicable fraction—*

(1) *In general.* Except as otherwise provided in this paragraph (c) and in §§ 26.2642-3 and 26.2642-4, the denominator of the applicable fraction is the value of the property transferred to the trust (or transferred in a direct skip not in trust) (as determined under § 26.2642-2) reduced by the sum of—

(i) Any Federal estate tax and any State death tax incurred by reason of the transfer that is chargeable to the trust and is actually recovered from the trust;

(ii) The amount of any charitable deduction allowed under section 2055,

2106, or 2522 with respect to the transfer; and

(iii) In the case of a direct skip, the value of the portion of the transfer that is a nontaxable gift. See paragraph (c)(3) of this section for the definition of nontaxable gift.

(2) *Zero denominator.* If the denominator of the applicable fraction is zero, the inclusion ratio is zero.

(3) *Nontaxable gifts.* Generally, for purposes of chapter 13, a transfer is a nontaxable gift to the extent the transfer is excluded from taxable gifts by reason of section 2503(b) (after application of section 2513) or section 2503(e). However, a transfer to a trust for the benefit of an individual is not a nontaxable gift for purposes of this section unless—

(i) Trust principal or income may, during the individual's lifetime, be distributed only to or for the benefit of the individual; and

(ii) The assets of the trust will be includible in the gross estate of the individual if the individual dies before the trust terminates.

(d) *Examples.* The following examples illustrate the provisions of this section. See § 26.2652-2(d) *Examples 2 and 3* for illustrations of the computation of the inclusion ratio where the special (reverse QTIP) election may be applicable.

EXAMPLE 1. *Computation of the inclusion ratio.* T transfers \$100,000 to a newly-created irrevocable trust providing that income is to be accumulated for 10 years. At the end of 10 years, the accumulated income is to be distributed to T's child, C, and the trust principal is to be paid to T's grandchild. T allocates \$40,000 of T's GST exemption to the trust on a timely-filed gift tax return. The applicable fraction with respect to the trust is .40 (\$40,000 (the amount of GST exemption allocated to the trust) over \$100,000 (the value of the property transferred to the trust)). The inclusion ratio is .60 ($1 - .40$). If the maximum Federal estate tax rate is 55 percent at the time of a GST, the rate of tax applicable to the transfer (applicable rate) will be .333 (55 percent (the maximum estate tax rate) \times .60 (the inclusion ratio)).

EXAMPLE 2. *Gift entirely nontaxable.* On December 1, 1996, T transfers \$10,000 to an irrevocable trust for the benefit of T's grandchild, GC. GC possesses a right to withdraw any contributions to the trust such that the entire transfer qualifies for the annual exclusion under section 2503(b). Under the terms of the trust, the income is to be paid to GC

for 10 years or until GC's prior death. Upon the expiration of GC's income interest, the trust principal is payable to GC or GC's estate. The transfer to the trust is a direct skip. T made no prior gifts to or for the benefit of GC during 1996. The entire \$10,000 transfer is a nontaxable transfer. For purposes of computing the tax on the direct skip, the denominator of the applicable fraction is zero, and thus, the inclusion ratio is zero.

EXAMPLE 3. *Gift nontaxable in part.* T transfers \$12,000 to an irrevocable trust for the benefit of T's grandchild, GC. Under the terms of the trust, the income is to be paid to GC for 10 years or until GC's prior death. Upon the expiration of GC's income interest, the trust principal is payable to GC or GC's estate. Further, GC has the right to withdraw \$10,000 of any contribution to the trust such that \$10,000 of the transfer qualifies for the annual exclusion under section 2503(b). The amount of the nontaxable transfer is \$10,000. Solely for purposes of computing the tax on the direct skip, T's transfer is divided into two portions. One portion is equal to the amount of the nontaxable transfer (\$10,000) and has a zero inclusion ratio; the other portion is \$2,000 (\$12,000 - \$10,000). With respect to the \$2,000 portion, the denominator of the applicable fraction is \$2,000. Assuming that T has sufficient GST exemption available, the numerator of the applicable fraction is \$2,000 (unless T elects to have the automatic allocation provisions not apply). Thus, assuming T does not elect to have the automatic allocation not apply, the applicable fraction is one (\$2,000/\$2,000 = 1) and the inclusion ratio is zero (1 - 1 = 0).

EXAMPLE 4. *Gift nontaxable in part.* Assume the same facts as in *Example 3*, except T files a timely Form 709 electing that the automatic allocation of GST exemption not apply to the \$12,000 transferred in the direct skip. T's transfer is divided into two portions, a \$10,000 portion with a zero inclusion ratio and a \$2,000 portion with an applicable fraction of zero (0/\$2,000 = 0) and an inclusion ratio of one (1 - 0 = 1).

§ 26.2642-2 Valuation.

(a) *Lifetime transfers*—(1) *In general.* For purposes of determining the denominator of the applicable fraction, the value of property transferred during life is its fair market value on the effective date of the allocation of GST exemption. In the case of a timely allocation under § 26.2632-1(b)(2)(ii), the denominator of the applicable fraction is the fair market value of the property as finally determined for purposes of chapter 12.

(2) *Special rule for late allocations during life.* If a transferor makes a late al-

location of GST exemption to a trust, the value of the property transferred to the trust is the fair market value of the trust assets determined on the effective date of the allocation of GST exemption. Except as otherwise provided in this paragraph (a)(2), if a transferor makes a late allocation of GST exemption to a trust, the transferor may, solely for purposes of determining the fair market value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late allocation is made (valuation date). An election under this paragraph (a)(2) is not effective with respect to a life insurance policy or a trust holding a life insurance policy, if the insured individual has died. An allocation subject to the election contained in this paragraph (a)(2) is not effective until it is actually filed with the Internal Revenue Service. The election is made by stating on the Form 709 on which the allocation is made—

- (i) That the election is being made;
- (ii) The applicable valuation date; and
- (iii) The fair market value of the trust assets on the valuation date.

(b) *Transfers at death*—(1) *In general.* Except as provided in paragraphs (b) (2) and (3) of this section, in determining the denominator of the applicable fraction, the value of property included in the decedent's gross estate is its value for purposes of chapter 11. In the case of qualified real property with respect to which the election under section 2032A is made, the value of the property is the value determined under section 2032A provided the recapture agreement described in section 2032A(d)(2) filed with the Internal Revenue Service specifically provides for the signatories' consent to the imposition of, and personal liability for, additional GST tax in the event an additional estate tax is imposed under section 2032A(c). See § 26.2642-4(a)(4). If the recapture agreement does not contain these provisions, the value of qualified real property as to which the election under section 2032A is made is the fair market value of the property determined without regard to the provisions of section 2032A.

(2) *Special rule for pecuniary payments*—(i) *In general.* If a pecuniary payment is satisfied with cash, the denominator of the applicable fraction is the pecuniary amount. If property other than cash is used to satisfy a pecuniary payment, the denominator of the applicable fraction is the pecuniary amount only if payment must be made with property on the basis of the value of the property on—

(A) The date of distribution; or

(B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made.

(ii) *Other pecuniary amounts payable in kind.* The denominator of the applicable fraction with respect to any property used to satisfy any other pecuniary payment payable in kind is the date of distribution value of the property.

(3) *Special rule for residual transfers after payment of a pecuniary payment*—

(i) *In general.* Except as otherwise provided in this paragraph (b)(3), the denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment is the estate tax value of the assets available to satisfy the pecuniary payment reduced, if the pecuniary payment carries appropriate interest (as defined in paragraph (b)(4) of this section), by the pecuniary amount. The denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment that does not carry appropriate interest is the estate tax value of the assets available to satisfy the pecuniary payment reduced by the present value of the pecuniary payment. For purposes of this paragraph (b)(3)(i), the present value of the pecuniary payment is determined by using—

(A) The interest rate applicable under section 7520 at the death of the transferor; and

(B) The period between the date of the transferor's death and the date the pecuniary amount is paid.

(ii) *Special rule for residual transfers after pecuniary payments payable in kind.* The denominator of the applicable fraction with respect to any residual transfer after satisfaction of a pecuniary payment payable in kind is the date of distribution value of the property distributed in satisfaction of the residual transfer, unless the pecuniary payment must be satisfied on the basis of the value of the property on—

(A) The date of distribution; or

(B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made.

(4) *Appropriate interest*—(i) *In general.* For purposes of this section and §26.2654-1 (relating to certain trusts treated as separate trusts), appropriate interest means that interest must be payable from the date of death of the transferor (or from the date specified under applicable State law requiring the payment of interest) to the date of payment at a rate—

(A) At least equal to—

(1) The statutory rate of interest, if any, applicable to pecuniary bequests under the law of the State whose law governs the administration of the estate or trust; or

(2) If no such rate is indicated under applicable State law, 80 percent of the rate that is applicable under section 7520 at the death of the transferor; and

(B) Not in excess of the greater of—

(1) The statutory rate of interest, if any, applicable to pecuniary bequests under the law of the State whose law governs the administration of the trust; or

(2) 120 percent of the rate that is applicable under section 7520 at the death of the transferor.

(ii) *Pecuniary payments deemed to carry appropriate interest.* For purposes of this paragraph (b)(4), if a pecuniary payment does not carry appropriate interest, the pecuniary payment is considered to carry appropriate interest to the extent—

(A) The entire payment is made or property is irrevocably set aside to satisfy the entire pecuniary payment within 15 months of the transferor's death; or

(B) The governing instrument or applicable local law specifically requires the executor or trustee to allocate to the pecuniary payment a pro rata share of the income earned by the fund from which the pecuniary payment is to be made between the date of death of the transferor and the date of payment. For purposes of paragraph (b)(4)(ii)(A) of this section, property is irrevocably set aside if it is segregated and held in a separate account pending distribution.

(c) *Examples.* The following examples illustrate the provisions of this section:

EXAMPLE 1. *T transfers \$100,000 to a newly-created irrevocable trust on December 15, 1996.* The trust provides that income is to be paid to T's child for 10 years. At the end of the 10-year period, the trust principal is to be paid to T's grandchild. T does not allocate any GST exemption to the trust on the gift tax return reporting the transfer. On November 15, 1997, T files a Form 709 allocating \$50,000 of GST exemption to the trust. Because the allocation was made on a late filed return, the value of the property transferred to the trust is determined on the date the allocation is filed (unless an election is made pursuant to paragraph (a)(2) of this section to value the trust property as of the first day of the month in which the allocation document is filed with the Internal Revenue Service). On November 15, 1997, the value of the trust property is \$150,000. Effective as of November 15, 1997, the applicable fraction with respect to the trust is .333 (\$50,000 (the amount of GST exemption allocated to the trust) over \$150,000 (the value of the trust principal on the effective date of the GST exemption allocation)), and the inclusion ratio is .667 (1.0 - .333).

EXAMPLE 2. The facts are the same as in *Example 1*, except the value of the trust property is \$80,000 on November 15, 1997. The applicable fraction is .625 (\$50,000 over \$80,000) and the inclusion ratio is .375 (1.0 - .625).

EXAMPLE 3. T transfers \$100,000 to a newly-created irrevocable trust on December 15, 1996. The trust provides that income is to be paid to T's child for 10 years. At the end of the 10-year period, the trust principal is to be paid to T's grandchild. T does not allocate any GST exemption to the trust on the gift tax return reporting the transfer. On November 15, 1997, T files a Form 709 allocating \$50,000 of GST exemption to the trust. T

elects to value the trust principal on the first day of the month in which the allocation is made pursuant to the election provided in paragraph (a)(2) of this section. Because the late allocation is made in November, the value of the trust is determined as of November 1, 1997.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

§26.2642-3 Special rule for charitable lead annuity trusts.

(a) *In general.* In determining the applicable fraction with respect to a charitable lead annuity trust—

(1) The numerator is the adjusted generation-skipping transfer tax exemption (adjusted GST exemption); and

(2) The denominator is the value of all property in the trust immediately after the termination of the charitable lead annuity.

(b) *Adjusted GST exemption defined.* The adjusted GST exemption is the amount of GST exemption allocated to the trust increased by an amount equal to the interest that would accrue if an amount equal to the allocated GST exemption were invested at the rate used to determine the amount of the estate or gift tax charitable deduction, compounded annually, for the actual period of the charitable lead annuity. If a late allocation is made to a charitable lead annuity trust, the adjusted GST exemption is the amount of GST exemption allocated to the trust increased by the interest that would accrue if invested at such rate for the period beginning on the date of the late allocation and extending for the balance of the actual period of the charitable lead annuity. The amount of GST exemption allocated to a charitable lead annuity trust is not reduced even though it is ultimately determined that the allocation of a lesser amount of GST exemption would have resulted in an inclusion ratio of zero. For purposes of chapter 13, a charitable lead annuity trust is any trust providing an interest in the form of a guaranteed annuity described in §25.2522(c)-3(c)(2)(vi) of this chapter for which the transferor is allowed a charitable deduction for Federal estate or gift tax purposes.

(c) *Example.* The following example illustrates the provisions of this section:

EXAMPLE. T creates a charitable lead annuity trust for a 10-year term with the remainder payable to T's grandchild. T timely allocates an amount of GST exemption to the trust which T expects will ultimately result in a zero inclusion ratio. However, at the end of the charitable lead interest, because the property has not appreciated to the extent T anticipated, the numerator of the applicable fraction is greater than the denominator. The inclusion ratio for the trust is zero. No portion of the GST exemption allocated to the trust is restored to T or to T's estate.

§ 26.2642-4 Redetermination of applicable fraction.

(a) *In general.* The applicable fraction for a trust is redetermined whenever additional exemption is allocated to the trust or when certain changes occur with respect to the principal of the trust. Except as otherwise provided in this paragraph (a), the numerator of the redetermined applicable fraction is the sum of the amount of GST exemption currently being allocated to the trust (if any) plus the value of the nontax portion of the trust, and the denominator of the redetermined applicable fraction is the value of the trust principal immediately after the event occurs. The nontax portion of a trust is determined by multiplying the value of the trust assets, determined immediately prior to the event, by the then applicable fraction.

(1) *Multiple transfers to a single trust.* If property is added to an existing trust, the denominator of the redetermined applicable fraction is the value of the trust immediately after the addition reduced as provided in § 26.2642-1(c).

(2) *Consolidation of separate trusts.* If separate trusts created by one transferor are consolidated, a single applicable fraction for the consolidated trust is determined. The numerator of the redetermined applicable fraction is the sum of the nontax portions of each trust immediately prior to the consolidation.

(3) *Property included in transferor's gross estate.* If the value of property held in a trust created by the transferor, with respect to which an allocation was made at a time that the trust was not subject to an ETIP, is included in the transferor's gross estate, the applicable fraction is redetermined if additional GST exemption is allocated to

the property. The numerator of the redetermined applicable fraction is an amount equal to the nontax portion of the property immediately after the death of the transferor increased by the amount of GST exemption allocated by the executor of the transferor's estate to the trust. If additional GST exemption is not allocated to the trust, then, except as provided in this paragraph (a)(3), the applicable fraction immediately before death is not changed, if the trust was not subject to an ETIP at the time GST exemption was allocated to the trust. In any event, the denominator of the applicable fraction is reduced to reflect any federal or state, estate or inheritance taxes paid from the trust.

(4) *Imposition of recapture tax under section 2032A—*(i) If an additional estate tax is imposed under section 2032A and if the section 2032A election was effective (under § 26.2642-2(b)) for purposes of the GST tax, the applicable fraction with respect to the property is redetermined as of the date of death of the transferor. In making the redetermination, any available GST exemption not allocated at the death of the transferor (or at a prior recapture event) is automatically allocated to the property. The denominator of the applicable fraction is the fair market value of the property at the date of the transferor's death reduced as provided in § 26.2642-1(c) and further reduced by the amount of the additional GST tax actually recovered from the trust.

(ii) The GST tax imposed with respect to any taxable termination, taxable distribution, or direct skip occurring prior to the recapture event is recomputed based on the applicable fraction as redetermined. Any additional GST tax as recomputed is due and payable on the date that is six months after the event that causes the imposition of the additional estate tax under section 2032A. The additional GST tax is remitted with Form 706-A and is reported by attaching a statement to Form 706-A showing the computation of the additional GST tax.

(iii) The applicable fraction, as redetermined under this section, is also used in determining any GST tax imposed with respect to GSTs occurring after the date of the recapture event.

(b) *Examples.* The following examples illustrate the principles of this section:

EXAMPLE 1. *Allocation of additional exemption.* T transfers \$200,000 to an irrevocable trust under which the income is payable to T's child, C, for life. Upon the termination of the trust, the remainder is payable to T's grandchild, GC. At a time when no ETIP exists with respect to the trust property, T makes a timely allocation of \$100,000 of GST exemption, resulting in an inclusion ratio of .50. Subsequently, when the entire trust property is valued at \$500,000, T allocates an additional \$100,000 of T's unused GST exemption to the trust. The inclusion ratio of the trust is recomputed at that time. The numerator of the applicable fraction is \$350,000 (\$250,000 (the nontax portion as of the date of the allocation) plus \$100,000 (the GST exemption currently being allocated)). The denominator is \$500,000 (the date of allocation fair market value of the trust). The inclusion ratio is .30 ($1 - .70$).

EXAMPLE 2. *Multiple transfers to a trust, allocation both timely and late.* On December 10, 1993, T transfers \$10,000 to an irrevocable trust that does not satisfy the requirements of section 2642(c)(2). T makes identical transfers to the trust on December 10, 1994, 1995, 1996, and on January 15, 1997. Immediately after the transfer on January 15, 1997, the value of the trust principal is \$40,000. On January 14, 1998, when the value of the trust principal is \$50,000, T allocates \$30,000 of GST exemption to the trust. T discloses the 1997 transfer on the Form 709 filed on January 14, 1998. Thus, T's allocation is a timely allocation with respect to the transfer in 1997, \$10,000 of the allocation is effective as of the date of that transfer, and, on and after January 15, 1997, the inclusion ratio of the trust is .75 ($1 - (\$10,000/\$40,000)$). The balance of the allocation is a late allocation with respect to prior transfers to the trust and is effective as of January 14, 1998. In redetermining the inclusion ratio as of that date, the numerator of the redetermined applicable fraction is \$32,500 (\$12,500 ($.25 \times \$50,000$), the nontax portion of the trust on January 14, 1998) plus \$20,000 (the amount of GST exemption allocated late to the trust). The denominator of the new applicable fraction is \$50,000 (the value of the trust principal at the time of the late allocation).

EXAMPLE 3. *Excess allocation.* (i) T creates an irrevocable trust for the benefit of T's child and grandchild in 1996 transferring \$50,000 to the trust on the date of creation. T allocates no GST exemption to the trust on the Form 709 reporting the transfer. On July 1, 1997 (when the value of the trust property is \$60,000), T transfers an additional \$40,000 to the trust.

(ii) On April 15, 1998, when the value of the trust is \$150,000, T files a Form 709 reporting the 1997 transfer and allocating \$150,000 of

GST exemption to the trust. The allocation is a timely allocation of \$40,000 with respect to the 1997 transfer and is effective as of that date. Thus, the applicable fraction for the trust as of July 1, 1997 is .40 ($\$40,000/\$100,000$ ($\$40,000 + \$60,000$)).

(iii) The allocation is also a late allocation of \$90,000, the amount necessary to attain a zero inclusion ratio on April 15, 1998, computed as follows: \$60,000 (the nontax portion immediately prior to the allocation ($.40 \times \$150,000$)) plus \$90,000 (the additional allocation necessary to produce a zero inclusion ratio based on a denominator of \$150,000)/\$150,000 equals one and, thus, an inclusion ratio of zero. The balance of the allocation, \$20,000 (\$150,000 less the timely allocation of \$40,000 less the late allocation of \$90,000) is void.

EXAMPLE 4. *Undisclosed transfer.* (i) The facts are the same as in Example 3, except that on February 1, 1998 (when the value of the trust is \$150,000), T transfers an additional \$50,000 to the trust and the value of the entire trust corpus on April 15, 1998 is \$220,000. The Form 709 filed on April 15, 1998 does not disclose the 1998 transfer. Under the rule in § 26.2632-1(b)(2)(ii), the allocation is effective first as a timely allocation to the 1997 transfer; second, as a late allocation to the trust as of April 15, 1998; and, finally as a timely allocation to the February 1, 1998 transfer. As of April 15, 1998, \$55,000, a pro rata portion of the trust assets, is considered to be the property transferred to the trust on February 1, 1998 ($(\$50,000/\$200,000) \times \$220,000$). The balance of the trust, \$165,000, represents prior transfers to the trust.

(ii) As in EXAMPLE 3, the allocation is a timely allocation as to the 1997 transfer (and the applicable fraction as of July 1, 1997 is .40) and a late allocation as of 1998. The amount of the late allocation is \$99,000, computed as follows: $(.40 \times \$165,000 \text{ plus } \$99,000)/\$165,000 = \text{one}$.

(iii) The balance of the allocation, \$11,000 (\$150,000 less the timely allocation of \$40,000 less the late allocation of \$99,000) is a timely allocation as of February 1, 1998. The applicable fraction with respect to the trust, as of February 1, 1998, is .355, computed as follows: \$60,000 (the nontax portion of the trust immediately prior to the February 1, 1998 transfer ($.40 \times \$150,000$)) plus \$11,000 (the amount of the timely allocation to the 1998 transfer)/\$200,000 (the value of the trust on February 1, 1998, after the transfer on that date) = $\$71,000/\$200,000 = .355$.

(iv) The applicable fraction with respect to the trust, as of April 15, 1998, is .805 computed as follows: \$78,100 (the nontax portion immediately prior to the allocation ($.355 \times \$220,000$)) plus \$99,000 (the amount of the late allocation)/\$220,000 = $\$177,100/\$220,000 = .805$.

EXAMPLE 5. *Redetermination of inclusion ratio on ETIP termination.* (i) T transfers

\$100,000 to an irrevocable trust. The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild, GC, on the termination of T's income interest. The trustee has the power to invade trust principal for the benefit of GC during the term of T's income interest. The trust is subject to an ETIP while T holds the retained income interest. T files a timely Form 709 reporting the transfer and allocates \$100,000 of GST exemption to the trust. In year 4, when the value of the trust is \$200,000, the trustee distributes \$15,000 to GC. The distribution is a taxable distribution. Because of the existence of the ETIP, the inclusion ratio with respect to the taxable distribution is determined immediately prior to the occurrence of the GST. Thus, the inclusion ratio applicable to the year 4 GST is .50 ($1 - (\$100,000/\$200,000)$).

(ii) In year 5, when the value of the trust is again \$200,000, the trustee distributes another \$15,000 to GC. Because the trust is still subject to the ETIP in year 5, the inclusion ratio with respect to the year 5 GST is again computed immediately prior to the GST. In computing the new inclusion ratio, the numerator of the applicable fraction is reduced by the nontax portion of prior GSTs occurring during the ETIP. Thus, the numerator of the applicable fraction with respect to the GST in year 5 is \$92,500 ($\$100,000 - (.50 \times \$15,000)$) and the inclusion ratio applicable with respect to the GST in year 5 is .537 ($1 - (\$92,500/\$200,000) = .463$). Any additional GST exemption allocated on a timely ETIP return with respect to the GST in year 5 is effective immediately prior to the transfer.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

§ 26.2642-5 Finality of inclusion ratio.

(a) *Direct skips.* The inclusion ratio applicable to a direct skip becomes final when no additional GST tax (including additional GST tax payable as a result of a cessation, etc. of qualified use under section 2032A(c)) may be assessed with respect to the direct skip.

(b) *Other GSTs.* With respect to taxable distributions and taxable terminations, the inclusion ratio for a trust becomes final, on the later of—

(1) The expiration of the period for assessment with respect to the first GST tax return filed using that inclusion ratio (unless the trust is subject to an election under section 2032A in which case the applicable date under this subsection is the expiration of the period of assessment of any additional GST tax due as a result of a cessation,

etc. of qualified use under section 2032A); or

(2) The expiration of the period for assessment of Federal estate tax with respect to the estate of the transferor. For purposes of this paragraph (b)(2), if an estate tax return is not required to be filed, the period for assessment is determined as if a return were required to be filed and as if the return were timely filed within the period prescribed by section 6075(a).

[T.D. 8644, 60 FR 66903, Dec. 27, 1995, as amended at 61 FR 43656, Aug. 26, 1996]

§ 26.2652-1 Transferor defined; other definitions.

(a) *Transferor defined*—(1) *In general.* Except as otherwise provided in paragraph (a)(3) of this section, the individual with respect to whom property was most recently subject to Federal estate or gift tax is the transferor of that property for purposes of chapter 13. An individual is treated as transferring any property with respect to which the individual is the transferor. Thus, an individual may be a transferor even though there is no transfer of property under local law at the time the Federal estate or gift tax applies. For purposes of this paragraph, a surviving spouse is the transferor of a qualified domestic trust created by the deceased spouse that is included in the surviving spouse's gross estate, provided the trust is not subject to the election described in § 26.2652-2 (reverse QTIP election). A surviving spouse is also the transferor of a qualified domestic trust created by the surviving spouse pursuant to section 2056(d)(2)(B).

(2) *Transfers subject to Federal estate or gift tax.* For purposes of this chapter, a transfer is subject to Federal gift tax if a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). A transfer is subject to Federal estate tax if the value of the property is includible in the decedent's gross estate as determined under section 2031 or section 2103.

(3) *Special rule for certain QTIP trusts.* Solely for purposes of chapter 13, if a transferor of qualified terminable interest property (QTIP) elects under § 26.2652-2(a) to treat the property as if

the QTIP election had not been made (reverse QTIP election), the identity of the transferor of the property is determined without regard to the application of sections 2044, 2207A, and 2519.

(4) *Split-gift transfers.* In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513. The donor is treated as the transferor of one-half of the value of the entire property. See § 26.2632-1(c)(5) *Example 3*, regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

(5) *Examples.* The following examples illustrate the principles of this paragraph (a):

EXAMPLE 1. Identity of transferor. T transfers \$100,000 to a trust for the sole benefit of T's grandchild. The transfer is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). Thus, for purposes of chapter 13, T is the transferor of the \$100,000. It is immaterial that a portion of the transfer is excluded from the total amount of T's taxable gift by reason of section 2503(b).

EXAMPLE 2. Gift splitting and identity of transferor. The facts are the same as in EXAMPLE 1, except T's spouse, S, consents under section 2513 to split the gift with T. For purposes of chapter 13, S and T are each treated as a transferor of \$50,000 to the trust.

EXAMPLE 3. Change of transferor on subsequent transfer tax event. T transfers \$100,000 to a trust providing that all the net trust income is to be paid to T's spouse, S, for S's lifetime. T elects under section 2523(f) to treat the transfer as a transfer of qualified terminable interest property, and T does not make the reverse QTIP election under section 2652(a)(3). On S's death, the trust property is included in S's gross estate under section 2044. Thus, S becomes the transferor at the time of S's death.

EXAMPLE 4. Effect of transfer of an interest in trust on identity of the transferor. T transfers \$100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C's trans-

fer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

EXAMPLE 5. Effect of lapse of withdrawal right on identity of transferor. T transfers \$10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw \$10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire \$10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of \$5,000 or 5% of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13.

EXAMPLE 6. Effect of reverse QTIP election on identity of the transferor. T establishes a testamentary trust having a principal of \$500,000. Under the terms of the trust, all trust income is payable to T's surviving spouse, S, during S's lifetime. T's executor makes an election to treat the trust property as qualified terminable interest property and also makes the reverse QTIP election. For purposes of chapter 13, T is the transferor with respect to the trust. On S's death, the then full fair market value of the trust is includible in S's gross estate under section 2044. However, because of the reverse QTIP election, S does not become the transferor with respect to the trust; T continues to be the transferor.

EXAMPLE 7. Effect of reverse QTIP election on constructive additions. The facts are the same as in Example 6, except the inclusion of the QTIP trust in S's gross estate increased the Federal estate tax liability of S's estate by \$200,000. The estate does not exercise the right of recovery from the trust granted under section 2207A. Under local law, the beneficiaries of S's residuary estate (which bears all estate taxes under the will) could compel the executor to exercise the right of recovery but do not do so. Solely for purposes of chapter 13, the beneficiaries of the residuary estate are not treated as having made an addition to the trust by reason of their failure to exercise their right of recovery. Because of the reverse QTIP election, for GST purposes, the trust property is not

treated as includible in S's gross estate and, under those circumstances, no right of recovery exists.

EXAMPLE 8. *Effect of reverse QTIP election on constructive additions.* S, the surviving spouse of T, dies testate. At the time of S's death, S was the beneficiary of a trust with respect to which T's executor made a QTIP election under section 2056(b)(7). Thus, the trust is includible in S's gross estate under section 2044. T's executor also made the reverse QTIP election with respect to the trust. S's will provides that all death taxes payable with respect to the trust are payable from S's residuary estate. Since the transferor of the property is determined without regard to section 2044 and section 2207A, S is not treated as making a constructive addition to the trust by reason of the tax apportionment clause in S's will.

EXAMPLE 9. *Split-gift transfers.* T transfers \$100,000 to an inter vivos trust that provides T with an annuity payable for ten years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). When the trust terminates, the corpus is to be paid to T's grandchild, GC. T's spouse, S, consents under section 2513 to have the gift treated as made one-half by S. Under section 2513, only the actuarial value of the gift to GC is eligible to be treated as made one-half by S. However, because S is treated as the donor of one-half of the gift to GC, S becomes the transferor of one-half of the entire trust (\$50,000) for purposes of Chapter 13.

(b) *Trust defined*—(1) *In general.* A trust includes any arrangement (other than an estate) that has substantially the same effect as a trust. Thus, for example, arrangements involving life estates and remainders, estates for years, and insurance and annuity contracts are trusts. Generally, a transfer as to which the identity of the transferee is contingent upon the occurrence of an event is a transfer in trust; however, a transfer of property included in the transferor's gross estate, as to which the identity of the transferee is contingent upon an event that must occur within 6 months of the transferor's death, is not considered a transfer in trust solely by reason of the existence of the contingency.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (b):

EXAMPLE 1. *Uniform gifts to minors transfers.* T transfers cash to an account in the name of T's child, C, as custodian for C's child, GC (who is a minor), under a state statute substantially similar to the Uniform Gifts to

Minors Act. For purposes of chapter 13, the transfer to the custodial account is treated as a transfer to a trust.

EXAMPLE 2. *Contingent transfers.* T bequeaths \$200,000 to T's child, C, provided that if C does not survive T by more than 6 months, the bequest is payable to T's grandchild, GC. C dies 4 months after T. The bequest is not a transfer in trust because the contingency that determines the recipient of the bequest must occur within 6 months of T's death. The bequest to GC is a direct skip.

EXAMPLE 3. *Contingent transfers.* The facts are the same as in Example 2, except C must survive T by 18 months to take the bequest. The bequest is a transfer in trust for purposes of chapter 13, and the death of C is a taxable termination.

(c) *Trustee defined.* The trustee of a trust is the person designated as trustee under local law or, if no such person is so designated, the person in actual or constructive possession of property held in trust.

(d) *Executor defined.* For purposes of chapter 13, the executor is the executor or administrator of the decedent's estate. However, if no executor or administrator is appointed, qualified or acting within the United States, the executor is the fiduciary who is primarily responsible for payment of the decedent's debts and expenses. If there is no such executor, administrator or fiduciary, the executor is the person in actual or constructive possession of the largest portion of the value of the decedent's gross estate.

(e) *Interest in trust.* See § 26.2612-1(e) for the definition of *interest in trust*.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996, as amended by T.D. 8720, 62 FR 27498, May 20, 1997]

§ 26.2652-2 Special election for qualified terminable interest property.

(a) *In general.* If an election is made to treat property as qualified terminable interest property (QTIP) under section 2523(f) or section 2056(b)(7), the person making the election may, for purposes of chapter 13, elect to treat the property as if the QTIP election had not been made (reverse QTIP election). An election under this section is irrevocable. An election under this section is not effective unless it is made with respect to all of the property in the trust to which the QTIP election applies. See, however, § 26.2654-1(b)(1). Property that qualifies for a deduction

under section 2056(b)(5) is not eligible for the election under this section.

(b) *Time and manner of making election.* An election under this section is made on the return on which the QTIP election is made. If a protective QTIP election is made, no election under this section is effective unless a protective reverse QTIP election is also made.

(c) *Transitional rule.* If a reverse QTIP election is made with respect to a trust prior to December 27, 1995, and GST exemption has been allocated to that trust, the transferor (or the transferor's executor) may elect to treat the trust as two separate trusts, one of which has a zero inclusion ratio by reason of the transferor's GST exemption previously allocated to the trust. The separate trust with the zero inclusion ratio consists of that fractional share of the value of the entire trust equal to the value of the nontax portion of the trust under § 26.2642-4(a). The reverse QTIP election is treated as applying only to the trust with the zero inclusion ratio. An election under this paragraph (c) is made by attaching a statement to a copy of the return on which the reverse QTIP election was made under section 2652(a)(3). The statement must indicate that an election is being made to treat the trust as two separate trusts and must identify the values of the two separate trusts. The statement is to be filed in the same place in which the original return was filed and must be filed before June 24, 1996. A trust subject to the election described in this paragraph is treated as a trust that was created by two transferors. See § 26.2654-1(a)(2) for special rules involving trusts with multiple transferors.

(d) *Examples.* The following examples illustrate the provisions of this section:

EXAMPLE 1. *Special (reverse QTIP) election under section 2652(a)(3).* T transfers \$1,000,000 to a trust providing that all trust income is to be paid to T's spouse, S, for S's lifetime. On S's death, the trust principal is payable to GC, a grandchild of S and T. T elects to treat all of the transfer as a transfer of QTIP and also makes the reverse QTIP election for all of the property. Because of the reverse QTIP election, T continues to be treated as the transferor of the property after S's death for purposes of chapter 13. A taxable termination rather than a direct skip occurs on S's death.

EXAMPLE 2. *Election under transition rule.* In 1994, T died leaving \$4 million in trust for the benefit of T's surviving spouse, S. On January 16, 1995, T's executor filed T's Form 706 on which the executor elects to treat the entire trust as qualified terminable interest property. The executor also makes a reverse QTIP election. The reverse QTIP election is effective with respect to the entire trust even though T's executor could allocate only \$1 million of GST exemption to the trust. T's executor may elect to treat the trust as two separate trusts, one having a value of 25% of the value of the single trust and an inclusion ratio of zero, but only if the election is made prior to June 24, 1996. If the executor makes the transitional election, the other separate trust, having a value of 75% of the value of the single trust and an inclusion ratio of one, is not treated as subject to the reverse QTIP election.

EXAMPLE 3. *Denominator of the applicable fraction of QTIP trust.* T bequeaths \$1,500,000 to a trust in which T's surviving spouse, S, receives an income interest for life. Upon the death of S, the property is to remain in trust for the benefit of C, the child of T and S. Upon C's death, the trust is to terminate and the trust property paid to the descendants of C. The bequest qualifies for the estate tax marital deduction under section 2056(b)(7) as QTIP. The executor does not make the reverse QTIP election under section 2652(a)(3). As a result, S becomes the transferor of the trust at S's death when the value of the property in the QTIP trust is included in S's gross estate under section 2044. For purposes of computing the applicable fraction with respect to the QTIP trust upon S's death, the denominator of the fraction is reduced by any Federal estate tax (whether imposed under section 2001, 2101 or 2056A(b)) and State death tax attributable to the trust property that is actually recovered from the trust.

§ 26.2653-1 Taxation of multiple skips.

(a) *General rule.* If property is held in trust immediately after a GST, solely for purposes of determining whether future events involve a skip person, the transferor is thereafter deemed to occupy the generation immediately above the highest generation of any person holding an interest in the trust immediately after the transfer. If no person holds an interest in the trust immediately after the GST, the transferor is treated as occupying the generation above the highest generation of any person in existence at the time of the GST who then occupies the highest generation level of any person who may subsequently hold an interest in

the trust. See § 26.2612-1(e) for rules determining when a person has an interest in property held in trust.

(b) *Examples.* The following examples illustrate the provisions of this section:

EXAMPLE 1. *T transfers property to an irrevocable trust for the benefit of T's grandchild, GC, and great-grandchild, GGC.* During GC's life, the trust income may be distributed to GC and GGC in the trustee's absolute discretion. At GC's death, the trust property passes to GGC. Both GC and GGC have an interest in the trust for purposes of chapter 13. The transfer by T to the trust is a direct skip, and the property is held in trust immediately after the transfer. After the direct skip, the transferor is treated as being one generation above GC, the highest generation individual having an interest in the trust. Therefore, GC is no longer a skip person and distributions to GC are not taxable distributions. However, because GGC occupies a generation that is two generations below the deemed generation of T, GGC is a skip person and distributions of trust income to GGC are taxable distributions.

EXAMPLE 2. *T transfers property to an irrevocable trust providing that the income is to be paid to T's child, C, for life. At C's death, the trust income is to be accumulated for 10 years and added to principal. At the end of the 10-year accumulation period, the trust income is to be paid to T's grandchild, GC, for life. Upon GC's death, the trust property is to be paid to T's great-grandchild, GGC, or to GGC's estate. A GST occurs at C's death. Immediately after C's death and during the 10-year accumulation period, no person has an interest in the trust within the meaning of section 2652(c) and § 26.2612-1(e) because no one can receive current distributions of income or principal. Immediately after C's death, T is treated as occupying the generation above the generation of GC (the trust beneficiary in existence at the time of the GST who then occupies the highest generation level of any person who may subsequently hold an interest in the trust). Thus, subsequent income distributions to GC are not taxable distributions.*

§ 26.2654-1 Certain trusts treated as separate trusts.

(a) *Single trust treated as separate trusts—(1) Substantially separate and independent shares—(i) In general.* If a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for purposes of chapter 13. The phrase “substantially separate and

independent shares” generally has the same meaning as provided in § 1.663(c)-3 of this chapter. However, a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust. For purposes of this paragraph (a)(1), a trust is treated as created at the date of death of the grantor if the trust is includible in its entirety in the grantor's gross estate for Federal estate tax purposes. Further, treatment of a single trust as separate trusts under this paragraph (a)(1) does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts, unless the governing instrument expressly provides otherwise.

(ii) *Certain pecuniary amounts.* For purposes of this section, if a person holds the current right to receive a mandatory (i.e., nondiscretionary and noncontingent) payment of a pecuniary amount at the death of the transferor from an inter vivos trust that is includible in the transferor's gross estate, or a testamentary trust, the pecuniary amount is a separate and independent share if—

(A) The trustee is required to pay appropriate interest (as defined in § 26.2642-2(b)(4)(i) and (ii)) to the person; and

(B) If the pecuniary amount is payable in kind on the basis of value other than the date of distribution value of the assets, the trustee is required to allocate assets to the pecuniary payment in a manner that fairly reflects net appreciation or depreciation in the value of the assets in the fund available to pay the pecuniary amount measured from the valuation date to the date of payment.

(2) *Multiple transferors with respect to single trust—(i) In general.* If there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of chapter 13. Treatment of a single trust as separate trusts under this paragraph (a)(2) does not permit treatment of those portions as separate

trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts unless otherwise expressly provided in the governing instrument.

(ii) *Addition by a transferor.* If an individual makes an addition to a trust of which the individual is not the sole transferor, the portion of the single trust attributable to each separate trust is determined by multiplying the fair market value of the single trust immediately after the contribution by a fraction. The numerator of the fraction is the value of the separate trust immediately after the contribution. The denominator of the fraction is the fair market value of all the property in the single trust immediately after the transfer.

(3) *Severance of a single trust.* A single trust treated as separate trusts under paragraphs (a)(1) or (2) of this section may be divided at any time into separate trusts to reflect that treatment. For this purpose, the rules of paragraph (b)(1)(ii)(C) of this section apply with respect to the severance and funding of the severed trusts.

(4) *Allocation of exemption—(i) In general.* With respect to a separate share treated as a separate trust under paragraph (a)(1) or (2) of this section, an individual's GST exemption is allocated to the separate trust. See § 26.2632-1 for rules concerning the allocation of GST exemption.

(ii) *Automatic allocation to direct skips.* If the transfer is a direct skip to a trust that occurs during the transferor's lifetime and is treated as a transfer to separate trusts under paragraphs (a)(1) or (a)(2) of this section, the transferor's GST exemption not previously allocated is automatically allocated on a pro rata basis among the separate trusts. The transferor may prevent an automatic allocation of GST exemption to a separate share of a single trust by describing on a timely-filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) the transfer and the extent to which the automatic allocation is not to apply to a particular share. See

§ 26.2632-1(b) for rules for avoiding the automatic allocation of GST exemption.

(5) *Examples.* The following examples illustrate the principles of this section (a):

EXAMPLE 1. *Separate shares as separate trusts.* T transfers \$100,000 to a trust under which income is to be paid in equal shares for 10 years to T's child, C, and T's grandchild, GC (or their respective estates). The trust does not permit distributions of principal during the term of the trust. At the end of the 10-year term, the trust principal is to be distributed to C and GC in equal shares. The shares of C and GC in the trust are separate and independent and, therefore, are treated as separate trusts. The result would not be the same if the trust permitted distributions of principal unless the distributions could only be made from a one-half separate share of the initial trust principal and the distributee's future rights with respect to the trust are correspondingly reduced. T may allocate part of T's GST exemption under section 2632(a) to the share held for the benefit of GC.

EXAMPLE 2. *Separate share rule inapplicable.* The facts are the same as in *Example 1*, except the trustee holds the discretionary power to distribute the income in any proportion between C and GC during the last year of the trust. The shares of C and GC in the trust are not separate and independent shares throughout the entire term of the trust and, therefore, are not treated as separate trusts for purposes of chapter 13.

EXAMPLE 3. *Pecuniary payment as separate share.* T creates a lifetime revocable trust providing that on T's death \$500,000 is payable to T's spouse, S, with the balance of the principal to be held for the benefit of T's grandchildren. The value of the trust is includible in T's gross estate upon T's death. Under the terms of the trust, the payment to S is required to be made in cash, and under local law S is entitled to receive interest on the payment at an annual rate of 6 percent, commencing immediately upon T's death. For purposes of chapter 13, the trust is treated as created at T's death, and the \$500,000 payable to S from the trust is treated as a separate share. The result would be the same if the payment to S could be satisfied using noncash assets at their value on the date of distribution. Further, the result would be the same if the decedent's probate estate poured over to the revocable trust on the decedent's death and was then distributed in accordance with the terms of the trust.

EXAMPLE 4. *Pecuniary payment not treated as separate share.* The facts are the same as in *Example 3*, except the bequest to S is to be paid in noncash assets valued at their values as finally determined for Federal estate tax

purposes. Neither the trust instrument nor local law requires that the assets distributed in satisfaction of the bequest fairly reflect net appreciation or depreciation in all the assets from which the bequest may be funded. S's \$500,000 bequest is not treated as a separate share and the trust is treated as a single trust for purposes of chapter 13.

EXAMPLE 5. Multiple transferors to single trust. A transfers \$100,000 to an irrevocable generation-skipping trust; B simultaneously transfers \$50,000 to the same trust. As of the time of the transfers, the single trust is treated as two trusts for purposes of chapter 13. Because A contributed $\frac{2}{3}$ of the value of the initial corpus, $\frac{2}{3}$ of the single trust principal is treated as a separate trust created by A. Similarly, because B contributed $\frac{1}{3}$ of the value of the initial corpus, $\frac{1}{3}$ of the single trust is treated as a separate trust created by B. A or B may allocate their GST exemption under section 2632(a) to the respective separate trusts.

EXAMPLE 6. Additional contributions. A transfers \$100,000 to an irrevocable generation-skipping trust; B simultaneously transfers \$50,000 to the same trust. When the value of the single trust has increased to \$180,000, A contributes an additional \$60,000 to the trust. At the time of the additional contribution, the portion of the single trust attributable to each grantor's separate trust must be redetermined. The portion of the single trust attributable to A's separate trust immediately after the contribution is $\frac{3}{4}$ ($((\frac{2}{3} \times \$180,000) + \$60,000)/\$240,000$). The portion attributable to B's separate trust after A's addition is $\frac{1}{4}$.

EXAMPLE 7. Distributions from a separate share. The facts are the same as in *Example 6*, except that, after A's second contribution, \$50,000 is distributed to a beneficiary of the trust. Absent a provision in the trust instrument that charges the distribution against the contribution of either A or B, $\frac{3}{4}$ of the distribution is treated as made from the separate trust of which A is the transferor and $\frac{1}{4}$ from the separate trust of which B is the transferor.

EXAMPLE 8. Separate share rule inapplicable. T creates an irrevocable trust that provides the trustee with the discretionary power to distribute income or corpus to T's children and grandchildren. The trust provides that, when T's youngest child reaches age 21, the trust will be divided into separate shares, one share for each child of T. The income from a respective child's share will be paid to the child during the child's life with the remainder passing to such child's children (grandchildren of T). The separate shares that come into existence when the youngest child reaches age 21 will not be recognized as separate trusts for purposes of Chapter 13 because the shares did not exist from and at all times after the creation of the trust. Any allocation of GST exemption to the trust ei-

ther before or after T's youngest child reaches age 21 will apply with respect to the entire trust. Thus, the inclusion ratio will be the same with respect to any distribution from the trust or the separate shares. The result would be the same if the trust instrument provided that the trust was to be divided into separate trusts when T's youngest child reached age 21.

(b) *Division of a trust included in the gross estate*—(1) *In general.* The severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if—

(i) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or

(ii) The governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and

(A) The terms of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust;

(B) The severance occurs (or a reformation proceeding, if required, is commenced) prior to the date prescribed for filing the Federal estate tax return (including extensions actually granted) for the estate of the transferor; and

(C) Either—

(1) The new trusts are severed on a fractional basis. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a nonpro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding; or

(2) If the severance is required (by the terms of the governing instrument) to be made on the basis of a pecuniary amount, the pecuniary payment is satisfied in a manner that would meet the requirements of paragraph (a)(1)(ii) of

this section if it were paid to an individual.

(2) *Special rule.* If a court order severing the trust has not been issued at the time the Federal estate tax return is filed, the executor must indicate on a statement attached to the return that a proceeding has been commenced to sever the trust and describe the manner in which the trust is proposed to be severed. A copy of the petition or other instrument used to commence the proceeding must also be attached to the return. If the governing instrument of a trust or local law authorizes the severance of the trust, a severance pursuant to that authorization is treated as meeting the requirement of paragraph (b)(1)(ii)(B) of this section if the executor indicates on the Federal estate tax return that separate trusts will be created (or funded) and clearly sets forth the manner in which the trust is to be severed and the separate trusts funded.

(3) *Allocation of exemption.* An individual's GST exemption under §2632 may be allocated to the separate trusts created pursuant to this section at the discretion of the executor or trustee.

(4) *Examples.* The following examples illustrate the provisions of this section (b):

EXAMPLE 1. *Severance of single trust.* T's will establishes a testamentary trust providing that income is to be paid to T's spouse for life. At the spouse's death, one-half of the corpus is to be paid to T's child, C, or C's estate (if C fails to survive the spouse) and one-half of the corpus is to be paid to T's grandchild, GC, or GC's estate (if GC fails to survive the spouse). If the requirements of paragraph (b) of this section are otherwise satisfied, T's executor may divide the testamentary trust equally into two separate trusts, one trust providing an income interest to spouse for life with remainder to C, and the other trust with an income interest to spouse for life with remainder to GC. Furthermore, if the requirements of paragraph (b) of this section are satisfied, the executor or trustee may further divide the trust for the benefit of GC. GST exemption may be allocated to any of the divided trusts.

EXAMPLE 2. *Severance of revocable trust.* T creates an inter vivos revocable trust providing that, at T's death and after payment of all taxes and administration expenses, the remaining corpus will be divided into two trusts. One trust, for the benefit of T's spouse, is to be funded with the smallest amount that, if qualifying for the marital

deduction, will reduce the estate tax to zero. The other trust, for the benefit of T's descendants, is to be funded with the balance of the revocable trust corpus. The trust corpus is includible in T's gross estate. Each trust is recognized as a separate trust for purposes of chapter 13.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996, as amended at 61 FR 43656, Aug. 26, 1996]

26.2662-1 Generation-skipping transfer tax return requirements.

(a) *In general.* Chapter 13 imposes a tax on generation-skipping transfers (as defined in section 2611). The requirements relating to the return of tax depend on the type of generation-skipping transfer involved. This section contains rules for filing the required tax return. Paragraph (c)(2) of this section provides special rules concerning the return requirements for generation-skipping transfers pursuant to certain trust arrangements (as defined in paragraph (c)(2)(ii) of this section), such as life insurance policies and annuities.

(b) *Form of return—(1) Taxable distributions.* Form 706GS(D) must be filed in accordance with its instructions for any taxable distribution (as defined in section 2612(b)). The trust involved in a transfer described in the preceding sentence must file Form 706GS(D-1) in accordance with its instructions. A copy of Form 706GS(D-1) shall be sent to each distributee.

(2) *Taxable terminations.* Form 706GS(T) must be filed in accordance with its instructions for any taxable termination (as defined in section 2612(a)).

(3) *Direct skip—(i) Inter vivos direct skips.* Form 709 must be filed in accordance with its instructions for any direct skip (as defined in section 2612(c)) that is subject to chapter 12 and occurs during the life of the transferor.

(ii) *Direct skips occurring at death—(A) In general.* Form 706 or Form 706NA must be filed in accordance with its instructions for any direct skips (as defined in section 2612(c)) that are subject to chapter 11 and occur at the death of the decedent.

(B) *Direct skips payable from a trust.* Schedule R-1 of Form 706 must be filed in accordance with its instructions for

any direct skip from a trust if such direct skip is subject to chapter 11. See paragraph (c)(2) of this section for special rules relating to the person liable for tax and required to make the return under certain circumstances.

(c) *Person liable for tax and required to make return*—(1) *In general.* Except as otherwise provided in this section, the following person is liable for the tax imposed by section 2601 and must make the required tax return—

(i) The transferee in a taxable distribution (as defined in section 2612(b));

(ii) The trustee in the case of a taxable termination (as defined in section 2612(a));

(iii) The transferor (as defined in section 2652(a)(1)(B)) in the case of an inter vivos direct skip (as defined in section 2612(c));

(iv) The trustee in the case of a direct skip from a trust or with respect to property that continues to be held in trust; or

(v) The executor in the case of a direct skip (other than a direct skip described in paragraph (c)(1)(iv) of this section) if the transfer is subject to chapter 11. See paragraph (c)(2) of this section for special rules relating to direct skips to or from certain trust arrangements (as defined in paragraph (c)(2)(ii) of this section).

(2) *Special rule for direct skips occurring at death with respect to property held in trust arrangements*—(i) *In general.* In the case of certain property held in a trust arrangement (as defined in paragraph (c)(2)(ii) of this section) at the date of death of the transferor, the person who is required to make the return and who is liable for the tax imposed by chapter 13 is determined under paragraphs (c)(2)(iii) and (iv) of this section.

(ii) *Trust arrangement defined.* For purposes of this section, the term *trust arrangement* includes any arrangement (other than an estate) which, although not an explicit trust, has the same effect as an explicit trust. For purposes of this section, the term "explicit trust" means a trust described in §301.7701-4(a).

(iii) *Executor's liability in the case of transfers with respect to decedents dying on or after June 24, 1996 if the transfer is less than \$250,000.* In the case of a direct

skip occurring at death, the executor of the decedent's estate is liable for the tax imposed on that direct skip by chapter 13 and is required to file Form 706 or Form 706NA (and not Schedule R-1 of Form 706) if, at the date of the decedent's death—

(A) The property involved in the direct skip is held in a trust arrangement; and

(B) The total value of the property involved in direct skips with respect to the trustee of that trust arrangement is less than \$250,000.

(iv) *Executor's liability in the case of transfers with respect to decedents dying prior to June 24, 1996 if the transfer is less than \$100,000.* In the case of a direct skip occurring at death with respect to a decedent dying prior to June 24, 1996, the rule in paragraph (c)(2)(iii) of this section that imposes liability upon the executor applies only if the property involved in the direct skip with respect to the trustee of the trust arrangement, in the aggregate, is less than \$100,000.

(v) *Executor's right of recovery.* In cases where the rules of paragraphs (c)(2)(iii) and (iv) of this section impose liability for the generation-skipping transfer tax on the executor, the executor is entitled to recover from the trustee (if the property continues to be held in trust) or from the recipient of the property (in the case of a transfer from a trust), the generation-skipping transfer tax attributable to the transfer.

(vi) *Examples.* The following examples illustrate the application of this paragraph (c)(2) with respect to decedents dying on or after June 24, 1996:

EXAMPLE 1. *Insurance proceeds less than \$250,000.* On August 1, 1997, T, the insured under an insurance policy, died. The proceeds (\$200,000) were includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC, was named the sole beneficiary of the policy. The insurance policy is treated as a trust under section 2652(b)(1), and the payment of the proceeds to GC is a transfer from a trust for purposes of chapter 13. Therefore, the payment of the proceeds to GC is a direct skip. Since the proceeds from the policy (\$200,000) are less than \$250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.

EXAMPLE 2. *Aggregate insurance proceeds of \$250,000 or more.* Assume the same facts as in Example 1, except T is the insured under two

insurance policies issued by the same insurance company. The proceeds (\$150,000) from each policy are includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC1, was named the sole beneficiary of Policy 1, and T's other grandchild, GC2, was named the sole beneficiary of Policy 2. GC1 and GC2 are skip persons (as defined in section 2613). Therefore, the payments of the proceeds are direct skips. Since the total value of the policies (\$300,000) exceeds \$250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.

EXAMPLE 3. *Insurance proceeds of \$250,000 or more held by insurance company.* On August 1, 1997, T, the insured under an insurance policy, dies. The policy provides that the insurance company shall make monthly payments of \$750 to GC, T's grandchild, for life with the remainder payable to T's great grandchild, GGC. The face value of the policy is \$300,000. Since the proceeds continue to be held by the insurance company (the trustee), the proceeds are treated as if they were transferred to a trust for purposes of chapter 13. The trust is a skip person (as defined in section 2613(a)(2)) and the transfer is a direct skip. Since the total value of the policy (\$300,000) exceeds \$250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.

EXAMPLE 4. *Insurance proceeds less than \$250,000 held by insurance company.* Assume the same facts as in Example 3, except the policy provides that the insurance company shall make monthly payments of \$500 to GC and that the face value of the policy is \$200,000. The transfer is a transfer to a trust for purposes of chapter 13. However, since the total value of the policy (\$200,000) is less than \$250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.

EXAMPLE 5. On August 1, 1997, A, the insured under a life insurance policy, dies. The insurance proceeds on A's life that are payable under policies issued by Company X are in the aggregate amount of \$200,000 and are includible in A's gross estate. Because the proceeds are includible in A's gross estate, the generation-skipping transfer that occurs upon A's death, if any, will be a direct skip rather than a taxable distribution or a taxable termination. Accordingly, because the aggregate amount of insurance proceeds with respect to Company X is less than \$250,000, Company X may pay the proceeds without regard to whether the beneficiary is a skip person in relation to the decedent-transferor.

(3) *Limitation on personal liability of trustee.* Except as provided in paragraph (c)(3)(iii) of this section, a trustee is not personally liable for any increases in the tax imposed by section

2601 which is attributable to the fact that—

(i) A transfer is made to the trust during the life of the transferor for which a gift tax return is not filed; or

(ii) The inclusion ratio with respect to the trust, determined by reference to the transferor's gift tax return, is erroneous, the actual inclusion ratio being greater than the reported inclusion ratio.

(iii) This paragraph (c)(3) does not apply if the trustee has or is deemed to have knowledge of facts sufficient to reasonably conclude that a gift tax return was required to be filed or that the inclusion ratio is erroneous. A trustee is deemed to have knowledge of such facts if the trustee's agent, employee, partner, or co-trustee has knowledge of such facts.

(4) *Exceptions—(i) Legal or mental incapacity.* If a distributee is legally or mentally incapable of making a return, the return may be made for the distributee by the distributee's guardian or, if no guardian has been appointed, by a person charged with the care of the distributee's person or property.

(ii) *Returns made by fiduciaries.* See section 6012(b) for a fiduciary's responsibilities regarding the returns of decedents, returns of persons under a disability, returns of estates and trusts, and returns made by joint fiduciaries.

(d) *Time and manner of filing return—(1) In general.* Forms 706, 706NA, 706GS(D), 706GS(D-1), 706GS(T), 709, and Schedule R-1 of Form 706 must be filed with the Internal Revenue Service office with which an estate or gift tax return of the transferor must be filed. The return shall be filed—

(i) *Direct skip.* In the case of a direct skip, on or before the date on which an estate or gift tax return is required to be filed with respect to the transfer (see section 6075(b)(3)); and

(ii) *Other transfers.* In all other cases, on or before the 15th day of the 4th month after the close of the calendar year in which such transfer occurs. See paragraph (d)(2) of this section for an exception to this rule when an election is made under section 2624(c) to value property included in certain taxable terminations in accordance with section 2032.

(2) *Exception for alternative valuation of taxable termination.* In the case of a taxable termination with respect to which an election is made under section 2642(c) to value property in accordance with section 2032, a Form 706GS(T) must be filed on or before the 15th day of the 4th month after the close of the calendar year in which the taxable termination occurred, or on or before the 10th month following the month in which the death that resulted in the taxable termination occurred, whichever is later.

(e) *Place for filing returns.* See section 6091 for the place for filing any return, declaration, statement, or other document, or copies thereof, required by chapter 13.

(f) *Lien on property.* The liens imposed under sections 6324, 6324A, and 6324B are applicable with respect to the tax imposed under chapter 13. Thus, a lien under section 6324 is imposed in the amount of the tax imposed by section 2601 on all property transferred in a generation-skipping transfer until the tax is fully paid or becomes uncollectible by reason of lapse of time. The lien attaches at the time of the generation-skipping transfer and is in addition to the lien for taxes under section 6321.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

§ 26.2663-1 Recapture tax under section 2032A.

See § 26.2642-4(a)(4) for rules relating to the recomputation of the applicable fraction and the imposition of additional GST tax, if additional estate tax is imposed under section 2032A.

§ 26.2663-2 Application of chapter 13 to transfers by nonresidents not citizens of the United States.

(a) *In general.* This section provides rules for applying chapter 13 of the Internal Revenue Code to transfers by a transferor who is a nonresident not a citizen of the United States (NRA transferor). For purposes of this section, an individual is a resident or citizen of the United States if that individual is a resident or citizen of the United States under the rules of chapter 11 or 12 of the Internal Revenue Code, as the case may be. Every NRA

transferor is allowed a GST exemption of \$1,000,000. See § 26.2632-1 regarding the allocation of the exemption.

(b) *Transfers subject to chapter 13—(1) Direct skips.* A transfer by a NRA transferor is a direct skip subject to chapter 13 only to the extent that the transfer is subject to the Federal estate or gift tax within the meaning of § 26.2652-1(a)(2). See § 26.2612-1(a) for the definition of direct skip.

(2) *Taxable distributions and taxable terminations.* Chapter 13 applies to a taxable distribution or a taxable termination to the extent that the initial transfer of property to the trust by a NRA transferor, whether during life or at death, was subject to the Federal estate or gift tax within the meaning of § 26.2652-1(a)(2). See § 26.2612-1(b) for the definition of a taxable termination and § 26.2612-1(c) for the definition of a taxable distribution.

(c) *Trusts funded in part with property subject to chapter 13 and in part with property not subject to chapter 13—(1) In general.* If a single trust created by a NRA transferor is in part subject to chapter 13 under the rules of paragraph (b) of this section and in part not subject to chapter 13, the applicable fraction with respect to the trust is determined as of the date of the transfer, except as provided in paragraph (c)(3) of this section.

(i) *Numerator of applicable fraction.* The numerator of the applicable fraction is the sum of the amount of GST exemption allocated to the trust (if any) plus the value of the nontax portion of the trust.

(ii) *Denominator of applicable fraction.* The denominator of the applicable fraction is the value of the property transferred to the trust reduced as provided in § 26.2642-1(c).

(2) *Nontax portion of the trust.* The nontax portion of a trust is a fraction, the numerator of which is the value of property not subject to chapter 13 determined as of the date of the initial completed transfer to the trust, and the denominator of which is the value of the entire trust. For example, T, a NRA transferor, transfers property that has a value of \$1,000 to a generation-skipping trust. Of the property transferred to the trust, property having a value of \$200 is subject to chapter

13 and property having a value of \$800 is not subject to chapter 13. The nontax portion is .8 (\$800 (the value of the property not subject to chapter 13) over \$1,000 (the total value of the property transferred to the trust)).

(3) *Special rule with respect to the estate tax inclusion period.* For purposes of this section, the provisions of § 26.2632-1(c), providing rules applicable in the case of an estate tax inclusion period (ETIP), apply only if the property transferred by the NRA transferor is subsequently included in the transferor's gross estate. If the property is not subsequently included in the gross estate, then the nontax portion of the trust and the applicable fraction are determined as of the date of the initial transfer. If the property is subsequently included in the gross estate, then the nontax portion and the applicable fraction are determined as of the date of death.

(d) *Examples.* The following examples illustrate the provisions of this section. In each example T, a NRA, is the transferor; C is T's child; and GC is C's child and a grandchild of T:

EXAMPLE 1. *Direct transfer to skip person.* T transfers property to GC in a transfer that is subject to Federal gift tax under chapter 12 within the meaning of § 26.2652-1(a)(2). At the time of the transfer, C and GC are NRAs. T's transfer is subject to chapter 13 because the transfer is subject to gift tax under chapter 12.

EXAMPLE 2. *Transfers of both U.S. and foreign situs property.* (i) T's will established a testamentary trust for the benefit of C and GC. The trust was funded with stock in a publicly traded U.S. corporation having a value on the date of T's death of \$100,000, and property not situated in the United States (and therefore not subject to estate tax) having a value on the date of T's death of \$400,000.

(ii) On a timely filed estate tax return (Form 706NA), the executor of T's estate allocates \$50,000 of GST exemption under section 2632(a) to the trust. The numerator of the applicable fraction is \$450,000, the sum of \$50,000 (the amount of exemption allocated to the trust) plus \$400,000 (the value of the nontax portion of the trust ($4/5 \times \$500,000$)). The denominator is \$500,000. Hence, the applicable fraction with respect to the trust is .9 ($\$450,000/\$500,000$), and the inclusion ratio is .1 ($1 - 9/10$).

EXAMPLE 3. *Inter vivos transfer of U.S. and foreign situs property to a trust and a timely allocation of GST exemption.* T establishes a

trust providing that trust income is payable to T's child for life and the remainder is to be paid to T's grandchild. T transfers property to the trust that has a value of \$100,000 and is subject to chapter 13. T also transfers property to the trust that has a value of \$300,000 but is not subject to chapter 13. T allocates \$100,000 of exemption to the trust on a timely filed United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). The applicable fraction with respect to the trust is 1, determined as follows: \$300,000 (the value of the nontax portion of the trust) plus \$100,000 (the exemption allocated to the trust) / \$400,000 (the total value of the property transferred to the trust).

EXAMPLE 4. *Inter vivos transfer of U.S. and foreign situs property to a trust and a late allocation of GST exemption.* (i) In 1996, T transfers \$500,000 of property to an inter vivos trust the terms of which provide that income is payable to C, for life, with the remainder to GC. The property transferred to the trust consists of property subject to chapter 13 that has a value of \$400,000 on the date of the transfer and property not subject to chapter 13 that has a value of \$100,000. T does not allocate GST exemption to the trust. On the transfer date, the nontax portion of the trust is .2 ($\$100,000/\$500,000$) and the applicable fraction is also .2 determined as follows: \$100,000 (the value of the nontax portion of the trust) / \$500,000 (the value of the property transferred to the trust).

(ii) In 1999, when the value of the trust is \$800,000, T allocates \$100,000 of GST exemption to the trust. The applicable fraction of the trust must be recomputed. The numerator of the applicable fraction is \$260,000 (\$100,000 (the amount of GST exemption allocated to the trust)) plus \$160,000 (the value of the nontax portion of the trust as of the date of allocation ($.2 \times \$800,000$)). The denominator of the applicable fraction is \$800,000. Accordingly, the applicable fraction with respect to the trust after the allocation is .325 ($\$260,000/\$800,000$) and the inclusion ratio is .675 ($1 - .325$).

EXAMPLE 5. *Taxable termination.* The facts are the same as in Example 4 except that, in 2006, when the value of the property is \$1,200,000, C dies and the trust corpus is distributed to GC. The termination is a taxable termination. If no further GST exemption has been allocated to the trust, the applicable fraction remains .325 and the inclusion ratio remains .675.

EXAMPLE 6. *Estate Tax Inclusion Period.* (i) T transferred property to an inter vivos trust the terms of which provided T with an annuity payable for 10 years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). The trust also provided that, at the end of the trust term, the remainder will pass to GC or GC's estate. The property transferred to the

trust consisted of property subject to chapter 13 that has a value of \$100,000 and property not subject to chapter 13 that has a value of \$400,000. T allocated \$100,000 of GST exemption to the trust. If T dies within the 10 year period, the value of the trust principal will be subject to inclusion in T's gross estate to the extent provided in sections 2103 and 2104(b). Accordingly, the ETIP rule under paragraph (c)(3) of this section applies.

(ii) In year 6 of the trust term, T died. At T's death, the trust corpus had a value of \$800,000, and \$500,000 was includible in T's gross estate as provided in sections 2103 and 2104(b). Thus, \$500,000 of the trust corpus is subject to chapter 13 and \$300,000 is not subject to chapter 13. The \$100,000 GST exemption allocation is effective as of T's date of death. Also, the nontax portion of the trust and the applicable fraction are determined as of T's date of death. In this case, the nontax portion of the trust is .375, determined as follows: \$300,000 (the value of the trust not subject to chapter 13)/\$800,000 (the value of the trust). The numerator of the applicable fraction is \$400,000, determined as follows: \$100,000 (GST exemption previously allocated to the trust) plus \$300,000 (the value of the nontax portion of the trust). The denominator of the applicable fraction is \$800,000. Thus, the applicable fraction with respect to the trust is .50, unless additional exemption is allocated to the trust by T's executor or the automatic allocation rules of § 26.2632-1(d)(2) apply.

EXAMPLE 7. The facts are the same as in Example 6 except that T survives the termination date of T's retained annuity and the trust corpus is distributed to GC. Since the trust was not included in T's gross estate, the ETIP rules do not apply. Accordingly, the nontax portion of the trust and the applicable fraction are determined as of the date of the transfer to the trust. The nontax portion of the trust is .80 (\$400,000/\$500,000). The numerator of the applicable fraction is \$500,000 determined as follows: \$100,000 (GST exemption allocated to the trust) plus

\$400,000 (the value of the nontax portion of the trust). Accordingly, the applicable fraction is 1, and the inclusion ratio is zero.

(e) *Transitional rule for allocations for transfers made before December 27, 1995.* If an NRA made a GST (inter vivos or testamentary) after December 23, 1992, and before December 27, 1995 that is subject to chapter 13 (within the meaning of § 26.2663-2), the NRA will be treated as having made a timely allocation of GST exemption to the transfer in a calendar year in the order prescribed in section 2632(c). Thus, a NRA's unused GST exemption will initially be treated as allocated to any direct skips made during the calendar year and then to any trusts with respect to which the NRA made transfers during the same calendar year and from which a taxable distribution or a taxable termination may occur. Allocations within the above categories are made in the order in which the transfers occur. Allocations among simultaneous transfers within the same category are made pursuant to the principles of section 2632(c)(2). This transitional allocation rule will not apply if the NRA transferor, or the executor of the NRA's estate, as the case may be, elected to have an automatic allocation of GST exemption not apply by describing on a timely-filed Form 709 for the year of the transfer, or a timely filed Form 706NA, the details of the transfer and the extent to which the allocation was not to apply.

[T.D. 8644, 60 FR 66903, Dec. 27, 1995; 61 FR 29654, June 12, 1996]

PARTS 28–29 [RESERVED]